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OVERSIGHT HEARINGS ON THE CONDITION OF THE BANKING SYSTEM

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE BACKGROUND OF THE BANKING INDUSTRY AS IT STANDS TODAY FROM ACADEMIC AND OUTSIDE ANALYSIS, STATE BANKING REGULATORS, AND THE THREE FEDERAL REGULATORY AGENCIES. TOPICS INCLUDE THE GENERAL CONDITION OF THE INDUSTRY, MINIMUM CAPITAL LEVELS, AND THE ISSUE OF RISK TAKING

OCTOBER 5, 17, AND 25, 1989

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OVERSIGHT HEARINGS ON THE CONDITION OF THE BANKING SYSTEM

THURSDAY, OCTOBER 5, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Bryan, Garn, Heinz, D'Amato, and Bond.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. Let me invite all those who are here to find a seat, so that we can begin. The committee will come to order.

Let me welcome our distinguished panelists today. The committee today begins a series of hearings on the condition of the banking industry. We are starting with three hearings that will occur this month. Today, we are hearing from a distinguished panel of academic and outside analysts. On October 17 we are going to have State banking regulators from California, Connecticut, Florida, and Texas before us. Then, on the 25th of this month, we will have leaders from the three Federal regulatory agencies to come in and address these topics as well.

Depending upon what we learn in the course of those three hearings, we will make a judgment as to what further hearings may well be needed for us to pursue.

The background for this important look at the present situation stems from many causes. Today, I think the national news coverage that has been given to the banking industry's condition is contradictory. On the one hand, we have regulators that claim that by and large things are good and improving; but there are a number of analysts who argue that the situation is worse than the regulators are prepared to admit.

We want to get into the middle of that difference of opinion, to understand exactly where the industry stands at the moment. We are going to focus on four main issues, and I have asked our witnesses today to do that. The first being the condition of the industry generally. Are there insolvent and undercapitalized banks that are out there that are still being allowed to operate, and what risks may be associated with that?

Having just come through the S&L experience, we know that that can be a very costly strategy, and we do not want a replay of that situation.

Next would be the minimum capital levels. What level of bank capital best protects the taxpayers and the insurance fund from abuse, and yet can allow the banking industry to properly do its job and to flourish. The Comptroller of the Currency and the Chairman of the FDIC are currently in disagreement about the minimum capital levels, and that disagreement is disquieting.

Next, the issue of risk taking. There are concerns that flaws in the system of Federal deposit insurance, perhaps worsened by forbearance shown to weak banks, can actually encourage excessive risk taking. Early in the decade, undue concentrations of lending to LDC's and the agricultural and energy sectors of the economy led many banks into deep trouble. Today, there are stories in the press about excessive loans and direct investments in real estate and leveraged buy-outs. And of course, the international debt problem is still with us.

So we are concerned about that. There are a large number also and variety of products that are not eligible for deposit insurance. Bank investment contracts, known as "BIC's," a relatively new development came into being during the development of FIRREA. Late last year, the FDIC proposed to expand the definition of a deposit, and with it the extent of its deposit insurance obligations.

Finally, in the fourth area of supervision, regulation, and enforcement, the data provided to the committee by the regulators show that examiner hours per $100,000 of deposit have fallen substantially and consistently each year at all there agencies since 1975.

So serious questions arise whether these reductions occurred inadvertently, or in fact even as a result of deliberate policy choices. More importantly than that, are we able to adequately ensure safety and soundness of the degree that we ought to, in the face of these kinds of reduced resources of our time, in terms of the monitoring and supervision functions.

So I want to thank our witnesses. We are going to get right into it. I want to call on Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. First of all, let me thank you, Mr. Chairman, for opening this series of hearings. I think everybody knows, over the last decade we have held innumerable hearings on financial restructuring. In the Senate, we have passed bills on several occasions, including the Proxmire bill in 1988, and the House has refused to act.

This year, obviously, we have been preoccupied with the S&L bail-out bill. But I am pleased that we are beginning hearings again. The condition of the banking system is of primary concern to the Banking Committee, and we certainly must be vigilant in monitoring the competitive position of U.S. institutions. Competition for international markets is likely to become even much more important for domestic banks in the years ahead.

Today, we welcome four banking industry academics and consultants, and I look forward to hearing your testimony. In the past, I have often commented on how the lack of progressive Federal legislation has hampered the ability of domestic institutions to compete. We just passed a mammoth banking bill, but its main purpose was on addressing old problems and FSLIC.

The explosion of the commercial paper market, the expansion of money market mutual funds, and the consolidation of European markets in 1992, will all continue to provide serious competitive challenges to the U.S. financial institutions.

In these oversight hearings on the condition of the banking system, we need to look at ways to protect the interests of taxpayers, while providing competitive opportunities for domestic financial institutions. After we have heard from these witnesses today, we will also hear from State and Federal regulatory officials. There are several questions which need to be explored with these parties.

The recent public dispute between Robert Clarke and William Seidman over new banking leverage ratio indicates just how sensitive this area has become. In addition, the weakening real estate market in many areas of the country presents new problems for banks, increased potential risk to FDIC's depositor insurance funds.

To maintain the health of our financial services industry, in order for that industry to compete efficiently in a world economy, we certainly must consider how to more fully revitalize our banking laws and bring our financial system up to date.

I am certainly eager to hear from these witnesses today, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Before the start, I have a statement from Senator Cranston to be inserted in the record.

[The statement of Senator Cranston follows:]

STATEMENT OF SENATOR ALAN CRANSTON

Mr. Chairman, I want to commend you for holding this oversight hearing today on the condition of the banking system in the United States.

Over the last several decades, the banking system has become an inseparable part of a larger financial services industry. And indeed, with the final decade of the Twentieth Century now only months away, the need to modernize this country's financial services industry has never been more amply demonstrated. For years, this Committee has examined the dynamic changes that have revolutionized that industry at home and around the world. And yet, so far, Congress has found itself unable to fashion a new regulatory structure that can keep pace with those dramatic changes in a manner which promotes the safety and soundness of the industry while also maintaining competitiveness globally that is fundamental to our continued economic well being.

Mr. Chairman, the time for us to act is growing alarmingly short. The European Community is continuing to move toward the implementation of its "Europe 1992" unified market plan. And throughout the world the technological revolution that has created a global financial services marketplace continues to progress unabated.

The changes in the financial services industry are dynamic and inexorable. There simply is no way to turn back the clock to the time when our current financial services regulatory structure bore a rational connection to the marketplace it oversaw. Nor should there be.

The challenge this country faces in responding to these changes worldwide also presents us with a unique opportunity to move ahead. We are quickly reaching the point where we must summon the political will to take the steps necessary to keep this country's financial services industry competitive, or we will be completely overtaken by the revolutionary changes that have transformed the industry throughout the world.

Considering incremental changes to a system that was designed in the Depression Era of the 1930's falls far short of preparing us to compete effectively in the Twenty-first Century. We are no longer dealing just with a "banking industry" but with a broad-based financial services industry. Accordingly we must provide for a regulatory structure that treats today's full range of financial services activities in an even-handed manner and which promotes safety and soundness while also promoting competition. For it is only through full and fair competition that our financial services industry will remain strong.

It is with these considerations in mind that S. 530, the Depository Institution Affiliation Act was introduced in the 101st Congress by Senators D'Amato, Garn and me. I believe that S. 530 provides a fitting starting point for considering where the financial services industry should be heading in the 1990's and into the Twenty-first Century.

I look forward to hearing from our witnesses on these issues and I am ready for the task this committee faces in modernizing the legal framework for a forward looking and competitive American financial services industry.

Thank you, Mr. Chairman.

The CHAIRMAN. We have Mr. Kaufman, Mr. Litan, Mr. McDermott, and Mr. Sheshunoff with us, coming from various points from across the country and bringing different vantage points to this problem. So we will ask you each to make your presentation in that order. We have the statements that you have given us. We will make those part of the record. I would appreciate, to the extent that you can, that you go right to the critical points that you want to really flag for us.

We will start with you, Dr. Kaufman.

STATEMENT OF GEORGE G. KAUFMAN, JOHN F. SMITH PROFESSOR OF FINANCE AND ECONOMICS, LOYOLA UNIVERSITY OF CHICAGO, CHICAGO, IL

Mr. KAUFMAN. Thank you, Senator.

I am pleased to testify on the condition of the banking industry. I will summarize my written statement, which I would like to put in the record.

The state of the banking industry is far healthier than that of the thrift industry, but it is not healthy enough to withstand shocks similar in relative magnitude to those that have rocked the thrift industry in the past decade. It is important that the banking industry be strengthened now, in order to prevent a replay of the costly thrift debacle. What needs to be done to prevent a banking crisis?

The two key phrases are capital and mandatory recapitalization of insufficiently capitalized banks before they have exhausted their capital and are economically insolvent so that they cannot repay their depositors in full and on time.

The Shadow Financial Regulatory Committee, an independent public interest group of banking experts of which I am cochair, has a proposal that will promote a safer banking industry without sacrificing either efficiency or service to the customer. I will discuss this proposal in more detail later.

The CHAIRMAN. I am going to have you pull the mike a little closer, if you would. I want to make sure that people behind you in the back of the room can hear you clearly.

Mr. KAUFMAN. Is this better?

The CHAIRMAN. Yes.

Mr. KAUFMAN. In your invitation letter, you requested that I respond to six questions. I will do so briefly.

One: Am I satisfied that commercial banks and their holding companies have enough capital to protect the public interest and avoid a future crisis at the bank insurance fund?

No. And I cannot emphasize "no" strongly enough. Capital in the banking system today is artificially low because of Federal deposit insurance. Before the introduction of the FDIC, banks held much higher capital ratios, on average in excess of 20 percent of their assets.

In addition, shareholders of national banks and some State banks were subject to personal liability beyond the value of their shares and bank off-balance sheet assets and liabilities were substantially lower; so that, for purposes of comparison to today's ratios, yesteryears' ratios should be adjusted upward.

For some large banks today, the dollar magnitude of their off-balance sheet activities matches and may even exceed that of their recorded on-balance sheet activities.

Other financial industries that are not protected by the Federal safety net, such as finance and insurance companies, maintain capital ratios between 10 and 20 percent, or about double those of banks. Investment banks maintain low capital ratios, but the capital is actual economic capital valued at market prices, not accounting capital, much of which is only hot air that is not available to absorb losses.

Witness for example that only two investment banking houses failed as an aftermath of the October 1987 stock market crisis, and none were kept alive by Government assistance, as were many banks and thrifts.

Federal deposit insurance has effectively permitted banks to substitute Government capital for private capital; but the Government is an unrecognized and disadvantaged shareholder. It receives none of the benefits of private shareholders, such as dividends, and yet shares in the costs of share ownership, such as the bank's losses. The private shareholders benefit at the expense of the Government. This is not good public policy.

Two: Am I confident that earnings reported for the banking industry reflect the true earnings performance of the industry?

No. Earnings are reported according to generally accepted accounting principles, which do not require write-downs of either loans that are still performing in terms of paying interest on schedule but whose future looks sufficiently shaky that they have been written down in value by the market, or of portfolio investment securities, whose prices have declined from cost as a result of interest rate increases. Thus, current earnings may be overstated.

On the other hand, reported earnings may be understated by failing to reflect market appreciation on assets that have not been sold and by including loan charge-offs that occurred economically in earlier periods, such as those recently announced by Chase Manhattan, Manufacturers Hanover Trust, and Morgan Guaranty. To be truly meaningful, bank income statements, like bank balance sheets, need to be reported in market value terms.

Three: Do I have concerns about the portfolio composition—particular real estate, LBOs and LDC lending—of banks and holding companies?

Again, in the absence of market value reporting, it is difficult to tell. The real estate loans of banks in some sections of the country are soft because their local economies are soft. But in many cases, the banks asked for trouble by lending a high percentage of the value of the collateral which, to make matters worse, was often deliberately overvalued by the use of questionable appraisal procedures.

LDC debt is a lesser concern, because it is basically held by a few large banks, is reported separately, and its market value can be readily computed by applying the discount at which the debt trades in the marketplace. This effectively represents an example of the benefits of market value accounting in action. We know the true picture.

Four: Am I satisfied that the regulators are successfully meeting their examination, supervision, regulation, and enforcement responsibilities?

This is also a difficult question to answer, because of the difficulty of measuring risk accurately. A number of my colleagues analyzed the adequacy of examination and supervision in a study for the American Bankers Association a few years ago. The study reviewed carefully the evidence with respect to the ability of examination ratings to predict bank insolvencies, and concluded that, on average, the ratings were not better than the predictions that could have been obtained by analyzing publicly reported financial data for the same banks.

A new thorough study of the success and cost effectiveness of traditional field examination and supervision procedures in affecting risk taking and preventing insolvencies relative to other procedures should receive high priority.

It should also be recognized that the effectiveness of both regulation and enforcement is affected by the underlying incentive structure. If the structure is incentive-incompatible, so that the means run counter to the ends, regulation and enforcement become exceedingly difficult as the regulated institutions search out end-runs.

In most cases, it would be cost-effective to restructure the incentive system, rather than to intensify regulation and enforcement. The last would be a never-ending task, and would require running faster and faster just to stay in place. The burden on the regulators and enforcers would become even greater, and would be unfair to them.

Five: What is my forecast of the condition of the banking industry in the next year?

I defer to my more expert colleagues on the panel on this question; but the concern of regulators and those providing oversight should focus on what could happen in the lean years, and they should start now on policies that could prevent outcomes that are costly to the public welfare.

The lack of concern over the thrift industry in the 1950's and 1960's contributed greatly to the large magnitude of their problems in the 1980's, as you pointed out in your introductory remarks, Mr. Chairman.

Time bombs should be disarmed while they are still ticking, and before they explode. That should be the lesson of the S&L crisis. Thus, the consequences of a number of alternative scenarios, including a few dramatically pessimistic or worst-case scenarios, should be simulated for a longer number of future years by the FDIC as part of its quarterly reporting required by FIRREA.

Six: What plan of action do I believe the regulators should adopt to strengthen the banking industry and remedy any deficiencies you perceive in their activities?

Because one of the most, if not the most, fundamental problems in the banking industry today is the structure of Federal deposit insurance, any solution needs to be pointed in that direction.

My preferred solution, and that of the Shadow Financial Regulatory Committee, is not to eliminate or even to modify deposit insurance greatly. Rather, we prefer to make it effectively redundant.

We do this by requiring banks to hold higher capital ratios; progressively increasing regulatory sanctions on them in terms of increased supervision, reduced freedom of operations, limitations on dividend payments, and so on, as their capital-asset ratios deteriorate; and requiring mandatory recapitalization by the present or new owners when the bank's capital ratio declines to some preannounced low but positive number.

If the bank is successfully recapitalized at that point, no losses are incurred by either depositors or the deposit insurance agency. Because of this, depositors would have little reason to run, and the stability of the banking system would be increased.

I will skip over the details of the proposal, which are discussed in the Shadow Committee's policy statement No. 41 which is attached to my written statement. However, in a nutshell, the Shadow Committee's proposal would reinstate the full private market penalty for failure, and thereby make market regulation effective and permit reduction of Government regulation, without the high costs that taxpayers have borne in recent years.

This idea was recently cited as worthy of serious consideration by Federal Reserve Vice Chairman Manuel Johnson. I commend it to you for your serious consideration.

[The complete prepared statement of George G. Kaufman follows:]

THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY

Statement by
George G. Kaufman
John F. Smith Professor of Finance and Economics
Loyola University of Chicago

before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C.
October 5, 1989

The state of the commercial banking system is far healthier than that of the thrift industry. But it is not healthy enough to withstand shocks similar in relative magnitude to those that rocked the thrift industry in the last decade. It is important that the banking industry be strengthened now in order to prevent a replay of the costly thrift debacle. As with personal health, an ounce of prevention is worth a pound of cure.

Many, but not all, of the problems of the banking industry stem from overly generous federal deposit insurance. This is not a new argument. Indeed, one needs only to reread the congressional testimony in the early 1930s, when federal deposit insurance was first adopted, and the numerous studies and articles then published to remind oneself that the problems we are now observing were clearly foreseen by many analysts. But because of the severity of the financial crisis during the Great Depression, immediate, strong, and visible actions perceived to be directed at correcting the situation were politically necessary. We are now paying the consequences. What needs to be done to prevent another banking crisis?

The two key phrases are capital and mandatory recapitalization of insufficiently capitalized banks before they have exhausted their capital and are economically insolvent so that they cannot repay their depositors in full and on time. The Shadow Financial Regulatory Committee, an independent public interest group of banking experts of which I am co-chair, strongly believes that more capital is preferred to less and more timely regulatory recapitalization intervention is preferred to less timely recapitalization. (I attach a statement of purpose of the Committee, a list of its members, and a list of its policy statements issued to date.) I will discuss this proposal in more detail later in this statement. Sufficient bank capital - - and only sufficient bank capital - - protects the federal deposit insurance fund and thereby also the taxpayers, from bank losses.

In your invitation letter, you requested that I respond to six questions. I will do so.

1. **Are you satisfied that commercial banks and their holding companies have enough capital to protect the public interest and avoid a future crisis at the Bank Insurance Fund?**

No. And I cannot emphasize 'no' strongly enough. Capital in the banking system is artificially low because of federal deposit insurance. Before the introduction of the FDIC, banks held much higher capital ratios, on average in excess of 20 percent of their assets. In addition, shareholders of national banks and some state banks were subject to personal liability beyond the value of their shares (double liability) and bank off-balance sheet assets and liabilities were substantially lower so that, for purposes of comparison to today's ratios, yesteryears' ratios should be adjusted upward. For some large banks today, the dollar magnitude of their off-balance sheet activities matches and may even exceed that of their recorded on-balance sheet activities.

Other financial industries not protected by the federal safety net, such as finance and insurance companies, maintain capital ratios between 10 and 20 percent, or more than double those of banks. Investment banks maintain low capital ratios, but the capital is actual economic capital valued at market prices, not accounting capital, much of which is only "hot air" that is not available to absorb losses. Witness, for example, that only two investment banking houses failed as an aftermath of the October 1987 stock market crisis and none were kept alive by government assistance, as were many banks and thrifts. Federal deposit insurance has effectively permitted banks to substitute government capital for private capital. But the government is an unrecognized and disadvantaged shareholder. It receives none of the benefits of private shareholders, such as dividends and control over management, and yet shares in the costs of shareownership - - the bank's losses. The private shareholders benefit at the expense of the government. This is not good public policy!

This way of viewing the contribution of federal deposit insurance has an interesting implication for dealing with banks and, particularly, savings and loan associations that do not now meet the required minimum capital standards but are generating earnings. When private capital is exhausted in economic but not in accounting terms and the institution is not recapitalized, only government capital remains. In effect, the institution is nationalized. At this point, logic would suggest that, if the institution is to remain open for whatever reason, the government's contribution should be explicitly recognized by the issuance of stock certificates (either common or preferred) to it on which it receives dividend payments and which it can and must sell to the private sector to reprivatize the institution in no more than, say, two years. That is, if an institution is unable or unwilling to recapitalize itself, the government will do it for it. At present, if institutions have no private capital but positive earnings, dividends are paid to private shareholders that rightfully belong to the government. Private shareholders are effectively levering off the government. This recapitalization solution would be both fair and practical and make implicit government assistance more comparable to the explicit FDIC assistance to larger insolvent commercial banks since the Continental Illinois rescue in 1984.

Even 6 percent economic capital supplemented by 8 percent risk-based capital is insufficient and anything lower, such as 1 1/2 or 3 percent is just asking for trouble. Would, for example, any one of us lend meaningful amounts of funds to another person who has only 3 or 6 or possibly even 10 percent capital? I doubt it. As Brumbaugh, Carron, and Litan have shown in a recent study and as bank stock analysts know well, large bank capital ratios after adjustment for losses actually incurred but not yet booked are below the 6 percent standard. Moreover, any capital standards at any level are effective only if there are meaningful sanctions for declines below the minimum requirements (see attached policy statement number 44 of the Shadow Financial Regulatory Committee on capital requirements adopted September 18, 1989). Forbearance toward capital deficient banks must be a mandatory "no-no".

2. **Are you confident that earnings reported for the banking industry reflect the true earnings performance of the industry?**

No. Earnings are reported according to generally accepted accounting principles (GAAP), which do not require write-downs of either loans that are still performing in terms of paying interest on schedule but whose future looks sufficiently shaky that they have been written down in value by the market place or of portfolio investment securities, whose prices have declined from cost as a result of interest rate increases. Thus, current earnings may be overstated. On the other hand, reported earnings may be understated by failing to reflect market appreciations on assets that have not been sold and by including loan charge-offs that occurred economically in earlier periods, such as those Chase Manhattan, Manufacturers Hanover Trust, and Morgan Guaranty recently announced.

To be truly meaningful, bank income statements, like bank balance sheets, need to be reported in market value terms. Many stock analysts regularly attempt to make such conversions, and I defer to them on the meaningfulness of currently reported bank earnings. I just wish to remind the Committee of the questionable meaningfulness of the positive earnings reported in recent years by many failed thrifts and banks. Accounting gimmickry is not difficult to apply and is very tempting to institutions that wish to conceal their true condition or to escape the wrath of the regulators. As long as incentives exist to mislead, and there are legal means of doing so, bank management may reasonably be expected to use them.

3. **Do you have concerns about the portfolio composition (particular real estate, LBOs and LDC lending) of banks and holding companies?**

Again, in the absence of market value reporting it is difficult to tell. The real estate loans of banks in some sections of the country are soft because their local economies are soft. But in many of these cases, the banks asked for trouble by lending a high percentage of the value of the collateral, which, to make matters worse, was often deliberately overvalued by the use of questionable appraisal procedures. Accurate appraisal is a backbone of any sound lending program. It should be noted that bank regulators and Congress in FIRREA have both taken steps in recent years to improve the accuracy of the appraisal process used by banks. Compliance with these new procedures needs to be carefully monitored.

LDC debt is a lesser concern because it is basically held by a few large banks, is reported separately, and its market value can be readily computed by applying the discount at which the debt trades in the market place. This effectively represents an example of the benefits of market value accounting in action. We know the true picture. As Brumbaugh, Carron, and Litan report, LDC debt alone weakens but does not wipe out the capital of the major U.S. banks. But the picture with respect to other unbooked losses is less clear and the margin for error is small.

4. **Are you satisfied that the regulators are successfully meeting their examination, supervision, regulation, and enforcement responsibilities?**

This is also a difficult question to answer because of the difficulty of measuring risk accurately. A number of my colleagues and myself analyzed the adequacy of examination and supervision in a study for the American Bankers Association a few years ago, later published as a chapter in the book, George Benston et al, Perspectives on Safe and Sound Banking (MIT Press, 1986). The study reviewed carefully the evidence with respect to the ability of examination ratings to predict bank insolvencies and concluded that, on average, the ratings were not better than the predictions that could have been obtained by analyzing publicly reported financial data for the same banks. But even if they were not, this does not, ipso facto, suggest that examination/supervision contribute nothing to improving the safety of banks. There is also evidence that examination findings often do not trigger timely and appropriate supervisory responses. This has been documented for nearly all depository institution regulatory agencies, both federal and state, and has contributed significantly to the recent losses in the thrift industry, both nationally and particularly in Ohio and Maryland, where many thrifts were insured by state sponsored agencies. Improved coordination between examination and supervision is a necessity.

Particularly in light of the rapid technological advances in the banking industry that permit the development of ever newer and more complex ways to assume risk quickly, more frequent monitoring assumes greater importance. A thorough independent study of the success and cost effectiveness of traditional field examination and supervision procedures in affecting risk-taking and preventing insolvencies relative to other procedures should receive high priority.

The recent regulatory reorganizations mandated by FIRREA need to be monitored closely. Although the FDIC has a superior track record to FSLIC, particularly in recent years, the transfer of substantial additional responsibility could endanger its future performance by stretching its organizational structure and manpower overly thin. Rapid growth of any organization, including growth by acquisition of other organizations, frequently causes disharmony, disruptions, and growing pains and is accompanied by a reduction in the effectiveness of internal controls. This is likely to happen to the FDIC, particularly in the short-run.

It is also important to remember that, when things go smoothly, all parties - - bankers and regulators - - smell like roses. But when things go wrong, they stink like skunks. That is in part why we currently prefer to stand closer to commercial bank regulators than to savings and loan regulators.

The effectiveness of both regulation and enforcement is affected by the underlying incentive structure. If the structure is incentive-incompatible, so that the means run counter to the ends (as is the case with protecting the reserves of the deposit insurance funds but not scaling the premiums charged to the risk exposure of the insured banks), regulation and enforcement become exceedingly difficult as the regulated institutions search out end-runs. In most cases, it would be cost-effective to restructure the incentive system to make it incentive-compatible rather than to intensify regulation and enforcement. The last would be a never-ending task and would require running faster and faster just to stay in place. The burden on the regulators and enforcers would become even greater and would be unfair to them.

5. **What is your forecast of the condition of the banking industry in the next year?**

The future condition of any highly leveraged industry, be it banking or not, depends greatly on the magnitude and frequency of unexpected adverse shocks. Given the current inadequate capital position of the banking industry, additional shocks of the magnitude of those of recent years can do serious harm. This effect is amplified by the remaining restrictions on the ability of banks to reduce their risk exposures through diversification either along product line or geographically. In the absence of major shocks, it is probable that the underlying economic condition of the banks should continue to improve, possibly even faster than indicated by the reported GAAP numbers, which are likely to continue to be affected by the booking of previously incurred but not recognized losses.

But the concern of regulators and those providing oversight should focus on what could happen in the lean years and they should start on policies now that could prevent outcomes that are costly to the public welfare. The lack of concern over the thrift industry in the 1950 and 1960s contributed greatly to the large magnitude of their problems in the 1980s. Time bombs should be disarmed while they are still ticking and before they explode. That should be the lesson of the S&L crisis. Thus, the consequences of a number of alternative scenarios, including a few dramatically pessimistic or worst case scenarios, should be simulated for a longer number of future years as part of the quarterly reporting required from the FDIC by FIRREA.

6. **What plan of action do you believe the regulators should adopt to strengthen the banking industry and remedy any deficiencies you perceive in their activities.**

Because one of the most, if not the most, fundamental problem in the banking industry is the structure of federal deposit insurance, any solution needs to be pointed in that direction. My preferred solution, and that of the Shadow Financial Regulatory Committee, is not to eliminate or even modify deposit insurance greatly, other than not raising the account coverage beyond the present $100,000, possibly defined somewhat more strictly. Rather, we prefer to make it effectively redundant. We do this by requiring banks to hold higher capital ratios; progressively increasing regulatory sanctions on them in terms of increased supervision, reduced freedom of operations, limitations on dividend payments, and so on, as their performance deteriorates in terms of reductions in their capital-asset ratio; and requiring mandatory recapitalization by the present or new owners when the bank's capital ratio declines to some preannounced low but positive number. If the bank is successfully recapitalized at that point, no losses are incurred by either depositors or the deposit insurance agency. Because of this, depositors would have little reason to run and the stability of the banking system would be increased. I will skip over the details of the proposal, but attach a copy of the Shadow Committee's policy statement number 41 which was adopted on February 13, 1989 for reference. I believe that this plan can be implemented at low cost and with little disruption to the current system.

It is also important to recognize that deregulation, which is likely to continue on net driven by competitive forces and technological advances, does not mean no regulation. Rather, it means a transfer from government regulation to market regulation, which is the way all government unregulated industries are regulated. But, as unfortunately was widely overlooked in the early 1980s, for this change-over to work, market regulation and market discipline must be allowed to work. If not, there is truly no regulation or discipline at all - - a sure-fire recipe for financial disaster. And that is what happened with the thrifts and what must not be permitted to happen with the banks.

For example, the most important component of market discipline is the penalty for insolvency - - liquidation or reorganization of the firm with losses to shareholders and managers and possibly also to creditors if net worth becomes negative. The penalty for failure restricts risk taking in unregulated industries. Unfortunately, it has not been permitted to work fully in the thrift and banking industries for a number of reasons. It is often feared that, failures of depository institutions, unlike the failure of other firms, are contagious and spill-over to other, healthy institutions. Moreover, these institutions provide valuable money and credit services and their failure may restrict these services to the community. Regulators frequently are evaluated on their success in maintaining stability and delaying reorganization of insolvencies in the hopes that recovery may occur or that total collapse can be postponed to their successor's watch. Elected officials are responsive to their constituents and are biased towards protecting them if the cost can be laid off on a non-constituent, such as federal deposit insurance funds. However, available evidence provides little support for the first two reasons and the high costs of recent policies suggests the folly of postponing hard decisions in the hope that the problem will disappear. The incentive for regulators to forbear may be removed by Congress mandating that specific corrective action, such as recapitalization, be taken at specified performance levels.

The Shadow Committee's proposal would reinstate the full penalty for failure, make market regulation effective, and permit reduction of government regulation without the high costs that we have borne in recent years. This proposal was recently cited as worthy of serious consideration by Federal Reserve Vice-Chairman, Manuel Johnson. I recommend it for your serious consideration.

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6. Shadow Financial Regulatory Committee, "An Outline of a Program For Deposit Insurance and Regulatory Reform", Policy Statement No. 41, February 13, 1989.

7. Shadow Financial Regulatory Committee, "The Comptroller of the Currency's Proposal for a Minimum Bank Leverage Ratio", Policy Statement No. 44, September 18, 1989.

SHADOW FINANCIAL REGULATORY COMMITTEE

Statement of Purpose and Membership

The Shadow Financial Regulatory Committee is a group of independent experts on the financial services industry and its regulatory structure.

The purposes of the Committee are: (1) to identify and analyze developing trends and ongoing events that promise to affect the efficiency and safe operation of sectors of the financial services industry, (2) to explore the spectrum of short-and long-term implications of emerging problems and policy changes, (3) to help develop appropriate private, regulatory and legislative responses to such problems, and (4) to assess and respond to proposed and actual public policy initiatives with respect to their impact on the public interest.

The results of the Committee's deliberations are intended to increase the awareness and sensitivity of members of the financial services industry, public policy makers, the communications media and the general public to the importance and implications of current problems, events and policy initiatives affecting the industry.

Members of the Shadow Financial Regulatory Committee are drawn from academic institutions and private organizations and reflect a wide range of views. The Committee is independent of any of the members' affiliated institutions or of sponsoring organizations. The recommendations of the Committee are its own. The only common denominators of the members are their public recognition as experts on the industry, and their preferences for market solutions to problems and the minimum degree of government regulation consistent with efficiency and safety.

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SHADOW FINANCIAL REGULATORY COMMITTEE

Policy Statements

	Title	Date Adopted
1.	Baker Plan for LDC Lending	February 1986
2.	FDIC Assistance to Save Failing Banks	February 1986
3.	Federal Reserve Junk Bond Ruling	February 1986
4.	Disclosure of Supervisory Actions and Examiners' Ratings	June 9, 1986
5.	Disclosure by Financial Institutions	June 9, 1986
6.	Risk-Related Bank Capital Guidelines	June 9, 1986
7.	Capital Forbearance Policy for Agricultural and Energy Banks	June 9, 1986
8.	Recapitalization of FSLIC and Zombie SLAs	June 9, 1986
9.	Facilitating the Interstate Takeover of Failing Depository Institutions	June 9, 1986
10.	Federal Home Loan Bank Board (FHLBB) Proposed Rules on Regulatory Capital and Nationwide Lending by Insured Savings and Loan Associations	August 5, 1986
11.	Federal Regulation of Activities of State Chartered Financial Institutions	November 17, 1986
12.	Conversion of S&Ls from FSLIC to FDIC Insurance Coverage	November 17, 1986
13.	Current Bank Holding Company Applications for Increased Securities Activities	November 17, 1986
14.	Policies Toward Troubled Depository Institutions	November 17, 1986
15.	Proper Financing of Private Party Securities Fully Guaranteed by the Federal Government	December 1, 1986
16.	FSLIC Recapitalization	February 9, 1987
17.	The Federal Reserve Board's "Source-of-Strength" Policy	May 18, 1987

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Policy Statements

18.	Regulatory Proposals for Risk-Related Capital Standards (Rev.)	May 18, 1987
19.	Supplementary Statement - Regulatory Proposals for Risk-Related Capital Statements	May 18, 1987
20.	Unnecessary Costs of FSLIC Recapitalization Program	September 14, 1987
21.	Debt to Less Developed Countries	November 13, 1987
22.	FSLIC Handling of Insolvent Thrift Institutions	November 13, 1987
23.	Implications of Stock Market Volatility	November 13, 1987
24.	Comments on the Federal Reserve Board's Proposal on the Acquisition of Healthy Thrift Institutions by Bank Holding Companies	November 13, 1987
25.	Moratorium on Bank Securities Activities	February 8, 1988
26.	Studies of the Stock Market Crash	February 8, 1988
27.	Disposal of FDIC Equity Interests in Assisted Banks	February 8, 1988
28.	The Southwest Plan for Ailing Thrift Institutions	February 8, 1988
29.	Regulatory Proposal for Risk-Related Capital Standards	February 8, 1988
30.	Disclosures by Financial Institutions of Financial Assets and Liabilities	February 8, 1988
31.	FDIC's New Policy on "Whole Bank" Takeovers	May 16, 1988
32.	Proposed FDIC Policy Statements Encouraging Independent Outside Audits of Thrifts	May 16, 1988
33.	Policy Responses to the Stock Market Crash	May 16, 1988
34.	FSLIC's Handling of Failed Thrifts	May 16, 1988

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Policy Statements

35.	Need to Make FSLIC and FDIC Assistance Deals Accountable	September 25, 1988
36.	The Need to Estimate the True Economic Condition of the FDIC	December 5, 1988
37.	Assessing FDIC Premiums Against U.S. Banks' Unsubordinated Debt and Deposits in Foreign Branch Offices	December 5, 1988
38.	An Outline of a Program for Deposit Insurance Reform	December 5, 1988
39.	The Administration's Plan to Resolve the Thrift Crisis	February 13, 1989
40.	Risk-Based Capital and Early Intervention Proposal of Federal Home Loan Bank Board	February 13, 1989
41.	An Outline of a Program for Deposit Insurance and Regulatory Reform (Revision of No. 38)	February 13,1989
42.	The On-Budget Status of Expenditures to Resolve Thrift Insolvencies	May 15, 1989
43.	Financial Institutions Reform, Recovery, and Enforcement Act of 1989	May 15, 1989
44.	The Comptroller of the Currency's Proposal for a Minimum Bank Leverage Ratio	September 18, 1989
45.	Federal Reserve Proposals to Modify the Payments System Risk Reduction Program	September 18, 1989
46.	Proposals to Modify Loan Loss Reserves for Third World Debt	September 18, 1989
47.	Congressionally-Mandated Accounting for Junk Bond Sales	September 18, 1989

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Statement of the Shadow Financial Regulatory Committee
on
Regulatory Proposal for Risk-Related Capital Standards

February 8, 1988

On January 27, 1988, the federal bank regulatory agencies released a revised proposal concerning risk-based capital adequacy standards. This new proposal, which is very similar to one put forward in February 1987, follows as a response to the December 1987 Basle Committee proposal for risk-based international capital standards. The chief differences between the present proposal and its predecessor are its focus on core capital, a relaxation of capital requirements applied to particular assets, and imposition of an additional minimum standard to be phased in by 1992.

These capital proposals have two objectives: (1) to increase the level of capital in banking organizations and (2) to reduce supposed inter-country competitive advantages created by differential regulatory capital standards.

On the first point of increasing the level of capital, which the Committee believes is the more important and pressing issue, the impact of implementing the standard is unclear. No evidence or analysis is provided on the net effects of application of the proposed standards on the existing adequacy of capital (as defined) in the banking industry or on the distribution of equity across different classes of banks.

On the issue of competitive equity, the committee questions whether it will be achieved by the proposal, given the arbitrary way that weights are assigned on asset classes. Furthermore, individual country supervisors have substantial discretion to determine which assets belong to which particular risk classes and to define supplementary capital.

In commenting on the previous proposal, the Committee noted several other weaknesses and problems. Some of these have been addressed in this proposal, other problems remain, and some new issues have arisen.

First, a proper risk-related capital or insurance premium system must be based on an effective system for monitoring capital. The proper measure of capital for regulatory purposes should be the market value of the assets less the market value of non subordinated liabilities. The proposed guidelines are based on historical values of assets and capital and are therefore defective.

Second, the proposals still assign essentially arbitrary weights to risk classes which are not supported with evidence on either market valuations of risk or historical loss experience in different classes of assets. Arbitrary asset weights become the basis for non-market credit allocation.

Third, the proposal focuses only on credit risk. Efforts should also proceed to recognize the importance of interest rate risk. Interest rate risk has been a substantial problem in the past and remains a significant concern.

Fourth, the risk ratings of particular asset categories do not sufficiently reflect the wide dispersion of risks that may exist within a given risk class. This is particularly a problem for the treatment of the lower weights assigned to municipal obligations.

Finally, the proposed weighting scheme does not recognize the value of diversification. The risk borne by a financial institution can be changed by diversification as well as by the choice of individual projects and leverage.

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Statement No. 41

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Statement of the Shadow Financial Regulatory Committee on An Outline of A Program for Deposit Insurance and Regulatory Reform

February 13, 1989.

The large number of current bank and thrift problems demonstrates clearly the inadequacy of federal regulatory policies and procedures to deal with insolvencies in a timely enough fashion to avoid undue financial burdens on both the insurance funds and the public at large. In particular, policies of regulatory forbearance and prolonged deferral of resolving problem cases, made possible by government insurance guarantees, permited economically insolvent institutions to keep operating. This has substantially increased the eventual costs of solving the problems which ultimately will be paid by taxpayers.

Fundamental reform is necessary and requires that: 1) the current regulatory and supervisory system be restructured to correct risk taking incentive problems and structural defects in the deposit insurance system, 2) an acceptable phase-in period be adopted so that solvent institutions would have time to adjust to the new regime, and 3) existing losses in the system be recognized as government liabilities and necessary steps taken to keep these losses from becoming larger.

The following proposal remedies major flaws in the system by minimizing incentives for insured depository institutions to take excessive risks. The proposal embodies:

- capital adequacy policies
- increased monitoring of asset values
- timely reorganization before a depository institution's economic capital is exhausted, and
- enhanced market incentives and rigorous supervisory enforcement

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as the foundations for new supervisory and financial regulatory policies that would ensure an efficient financial system that is equitable and safe. The suggested program would not only improve regulatory performance but also foster greater discipline in managerial decision making. Managers of federally insured institutions must understand that the economic consequences of their actions would become known and that additional funds must be invested when capital falls to insufficient levels. Finally, owners, managers and uninsured creditors must know that the federal safety net would not support mismanaged or economically insolvent institutions. The following are the major components of the proposal:

CAPITAL POLICY

Establish four explicit, predetermined ranges or tranches of capital-to-asset ratios with differing supervisory policies applicable to each tranche as follows:

1. Tranche 1 - ADEQUATE CAPITAL (e.g., 10% of assets or greater) - banks with capital above this minimum amount would be subject to "normal" (i.e., minimal) regulation and supervision.

2. Tranche 2 - FIRST LEVEL OF SUPERVISORY CONCERN (e.g., 6-9.9% of assets) - once a depository institution's capital ratio falls into this range it would be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority would have the discretion to require the institution: a) to submit a business plan to raise sufficient capital to attain Tranche 1 within a specified period of time, b) to suspend dividend payments or unapproved transfers of funds within a holding company system, and c) to restrict permissible asset growth.

3. Tranche 3 - SECOND LEVEL OF SUPERVISORY CONCERN (e.g., 3-5.9% of assets) - when an institution's capital ratio falls into this range it would be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt and unapproved outflows of funds to an institution's parent or affiliates would be mandated. Asset growth would be prohibited to prevent institutions from attempting to "grow" out of their problems. The institution would be required to submit, in addition to the business plan to increase capital required in Tranche 2, an emergency plan for its immediate recapitalization to Tranche 1 level.

4. Tranche 4 - MANDATORY RECAPITALIZATION AND REORGANIZATION (e.g., less than 3% of assets) - The federal deposit insurance agency is mandated to place the institution in a conservatorship; delayed supervisory response has been one of the causes of the level of existing losses. This conservator-

ship would be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, sale of the entire organization or sale of individual assets. Present owners would have the option of implementing quickly the plan submitted when the institution moved into Tranche 3, or electing not to inject further funds into the institution. If the owners elect not to recapitalize the institution, it would be sold or liquidated, and any residual value from its sale or liquidation of assets would be returned to subordinated debt holders and shareholders, after allowing for any costs incurred.

KEY CLARIFICATIONS AND FEATURES OF THE PROPOSED STRUCTURE

1. DEFINITION OF CAPITAL - Capital is defined as the difference between the market value of assets and the market value of liabilities (including so-called off-balance sheet items) other than indebtedness counted as capital for regulatory purposes because it is subordinated to the claims of the deposit insurance agency and has a maturity of at least one year.

2. MARKET VALUES - The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions. As a matter of implementation, it is envisioned that market valuation estimates would have three sources: a) directly observed market prices, b) prices derived from instruments of comparable tenor including maturity, credit quality and rate, and c) estimates based on generally accepted valuation principles. Parties expected to be involved in the development of valuation standards and procedures include the regulatory agencies, public accountants, market and valuation experts, and the industry itself. Once the estimation programs are in place (as they already are in many institutions) valuations should be relevant to both management and the supervisors.

3. SUPERVISION COSTS - Charges for supervision, regulation, examination and monitoring would be based upon the efforts required of the supervisors and paid for by the depository institution. Because examination and monitoring efforts increase as an institution's capital declines and risks assumed increase, agency charges would function in a manner analogous to risk-adjusted insurance premiums.

4. CHARTER SHIFTING - Institutions would be permitted to change their primary regulatory agency within the new structure. This serves as an incentive for the respective agencies to balance the costs of supervision with its benefits to the agency and to limit over zealous supervision.

3

5. ACCOUNTABILITY OF SUPERVISORS - Federal bank supervisors must report publicly to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1.

Supervisors would be responsible for assuring that the business and recapitalization plans are appropriate and are acted upon. Periodic General Accounting Office audits and yearly congressional oversight would be required to provide an element of discipline on the regulators to operate in accordance with the required standards.

6. REGULATORY RESPONSIBILITY IN TRANCHE 4 - The appropriate federal deposit insurance agency would be notified when an institution moved into Tranche 3 and would receive all supervisory reports, and other information in anticipation of having to assume control of the institution as it moves into Tranche 4. All institutions falling into Tranche 4 should be reorganized regardless of their size. Their losses would be charged pro rata to uninsured creditors.

7. CREATION OF SUPERVISORY AUDIT TRAIL - Use of tranches and required consultations would document regulatory problems encountered in attempting to value firms as their capital declines and they move through the Tranches. This should simplify resolution of controversy should an institution be forced into recapitalization or reorganization.

8. INSURANCE PREMIUMS - Explicit charges for insurance should be low under this system since only fraud cases and unusual market movements would impose significant losses on the insurance funds.

9. HOLDING COMPANIES AND PERMISSIBLE ACTIVITIES - Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue. Use of the suggested valuation scheme, however, does suggest that the primary criterion relevant for establishing the suitability of a bank activity should be the ability of the insurance agency to monitor the activity and to estimate its market value.

10. INSURANCE COVERAGE - Present deposit insurance coverage of $ 100,000 per customer need not be changed for the proposal to be effective. Indeed, were the proposal to be adopted, it would be doubtful that any depositors would lose funds, except those involved in frauds on banks.

11. DISCLOSURE - Regular reports to the supervisors embodying the market value of banks should be publicly available. This

would enable the Congress and public to monitor better the status and financial condition of banks and the performance of the supervisory agencies.

12. LARGE BANK FAILURES - All institutions that fall into Tranche 4 should be reorganized or allowed to "fail" regardless of their size. Any losses should be charged pro rata to equity holders and uninsured creditors. "Failure" means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Policies which differentiate among firms based on their size (e.g., "too big to pay off") present unacceptable incentive problems, provide inequitable treatment of creditors, and foster unfair competition.

13. MARKET DISCIPLINE - Under this proposal the supervisory authority rarely would have to close or reorganize a bank. The suspension of dividends and interest payments on subordinated debt required when a bank falls into the second level of supervisory concern (Tranche 3) should bring actions by stock and debt holders to correct poor performance and inject more capital in the bank to keep it from being taken over by the insurance agency.

TRANSITION

Except for institutions with zero or negative GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as 5 years. Unless they are immediately recapitalized, GAAP-insolvent institutions would not be kept in operation. Institutions that are not GAAP-insolvent would plan for a three-year phase-in of the program ending in 1992 (the final effective date of the current "risk-adjusted" capital program).

DEALING WITH EXISTING LOSSES IN THE SYSTEM

Dealing effectively with existing losses in the system requires: first, that they be explicitly recognized as residual full faith and credit liabilities of the government rather than merely liabilities of the insurance funds; second, that insolvent institutions promptly be recapitalized and/or reorganized, merged, sold or liquidated; and third, that methods be devised for prompt disposal of assets acquired during reorganization of insolvent institutions. Any financing method not based upon the full faith and credit of the U.S. government would necessarily be more expensive and, given the magnitude of the existing problem, inappropriate.

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Statement of the Shadow Financial Regulatory Committee

on

The Comptroller of the Currency's Proposal for a Minimum Bank Leverage Ratio

September 18, 1989

The Comptroller of the Currency (OCC) recently issued a proposed regulation to set a 3% minimum leverage ratio that national banks would be required to meet in addition to the 8% risk-based capital standard that will be fully implemented by 1992. The Shadow Financial Regulatory Committee agrees with the thrust of the Comptroller's conclusion that the risk-based capital system is inadequate to protect the deposit insurance system, but we have serious reservations about the specifics of the Comptroller's proposal. Our criticisms of the risk-based requirements are spelled out in Statements Nos. 18 and 29, issued May 18, 1987 and February 8, 1988.

We have urged, instead, the adoption of a structure of capital requirements that would call for increasingly strong supervisory actions as properly measured capital falls. The Committee's proposal was set forth in Statement No. 41, issued on February 13, 1989.

Our criticisms of the OCC proposal relate to:

(1) the definition of capital;

(2) the appropriate ratio requirement; and

(3) the action to be taken if the requirement is not met.

1. The appropriate definition of capital in terms of protection to bank creditors and the deposit

insurance system is the difference between the market value of assets (including intangibles) and the market value of those liabilities (including off-balance sheet items) that are not subordinated to the claims of the insurance agency. We reject as artificial the distinctions between first and second tier capital, as well as the concept of core capital.

If one prefers to think in terms of historical costs, or "book values," our view implies that subordinated debt and preferred stock and that part of the loan loss reserve, if any, that exceeds the expected loss in the loan portfolio, should not be excluded from capital. Similarly, it is inappropriate to deduct goodwill from the computation of capital if the goodwill represents a market estimate of the franchise value of the institution, although it is appropriate to ignore goodwill that does not reflect economic values.

2. We believe that the required ratio, with capital defined as above, should be significantly higher than the existing 6% standard (see Statement No. 41).

3. A meaningful capital standard must include clear rules that specify actions to be taken when requirements are not met. These actions are not spelled out in the OCC proposal. We could support the proposal if it were intended as the "trigger" for a mandatory recapitalization and reorganization rule, such as that described in our Statement No. 41.

We recognize that the OCC proposal may be intended to resolve the confusion over the applicability of the national bank capital standards to savings and loans as required by FIRREA. We might note that this confusion is an unfortunate result of an attempt at legislating detailed capital requirements and accounting definitions that are more appropriately left to the regulatory agencies. We warned about this danger in our Statement No. 43 on FIRREA, issued May 15, 1989.

Subcommittee on Financial Institutions
Supervision, Regulation and Insurance
House Committee on Banking, Finance and
Urban Affairs
September 20, 1989

THE NEED FOR TIMELY AND ACCURATE MEASURES OF FEDERAL DEPOSIT INSURERS' NET RESERVE POSITION

Edward J. Kane
Reese Professor of Banking and Monetary Economics
Ohio State University

Federal taxpayers are now officially responsible for making good any shortfall in the finances of the federal deposit-insurance funds. Each fund's claim on taxpayer resources broadly resembles a private corporation's claim on stockholders' contributed capital.

Among its other purposes, U.S. securities law attempts to see that stockholders receive information sufficient to monitor in timely fashion how well an enterprise's managers are administering corporate resources. For an insurance fund, the single most important piece of information taxpayers could regularly receive would be an accurate measure of the fund's net reserve position. By "net reserves," I mean the difference between an insurer's gross resources and the expected value of insured parties' current and future claims for payment from these reserves. In turn, the aggregate value of anticipated claims is the capitalized cost of enhancing the credit of the insurer's deposit-institution customers. This value may be conceived operationally as the risk-adjusted present value of a fund of reserves sufficient probabilistically both to finance the insurer's monitoring and policing efforts and to meet whatever additional cash flows would be required to cover shortfalls in insured institutions' ability to deliver payments due to insured depositors.

Our system of representative democracy makes your subcommittee one of taxpayers' first-line agents for monitoring the condition of the federal deposit-insurance funds. To enforce taxpayer interests faithfully, this committee needs to insist that accurate information be regularly reported to it on the value of these funds' net reserves .

The accounting information that Congress has been receiving from federal insurers is inadequate for the task of protecting taxpayer interests. The spectacular losses accrued by the defunct Federal Savings and Loan Insurance Corporation (FSLIC) should make this crystal-clear. The bulk of FSLIC's losses occurred and were apparent to Federal Home Loan Bank Board (FHLBB) staff many years before they were officially acknowledged by FHLBB and GAO accountants. For instance, former FHLBB Chairman Richard Pratt recently divulged that, as long ago as 1982, he judged the "depth of the thrift problem" (i.e., FSLIC's net reserves) to be a negative $100 billion (Federal Home Loan Bank of San Francisco, 1989, p. 62).

The problem with the accounting system under which federal insurers currently report is that insurers have no obligation to share such important, but institutionally embarrassing judgments with us. Each income and balance-sheet statement focuses on losses the fund actually resolves, to the exclusion of further losses that may reasonably be anticipated. The failure to incorporate FSLIC's clearly appraisable losses into the budgetary control loop as they were accumulating in the 1970s and early 1980s hid the true costs to taxpayers of authorities' giving into the temptation to cut insolvent firms a break. Such misguided leniency is the single most important cause of the immensity of the cleanup we face today.

To evaluate the condition of a deposit insurer prospectively, one must fashion an informed estimate of the extent to which the operations of its client base exposes the insurance fund to appraisable losses. One way to do this is to develop and combine two kinds of unreported information:

1. Estimates of the risk that different classes of institutions are or will become economically insolvent;
2. Estimates of the implicit and explicit losses the fund will incur in each class of insolvency.

To illustrate how such information might be framed, on December 5, 1988 the Shadow Financial Regulatory Committee (SFRC) issued a statement assessing the FDIC's net reserve position for yearend 1988. (Modelled on the Shadow Open Market Committee, the SFRC is a panel of four lawyers and eight economists to which Professor Eisenbeis and I belong that meets four times a year to prepare policy statements on current issues in financial regulation. The statement in question is attached here as an appendix.) Because it had to be based entirely on publicly available information, the SFRC labeled its calculation as only a "crude appraisal" and went on to write FDIC Chairman Seidman to request additional unpublished data that it could use to refine its initial estimates.

The Washington Post quoted FDIC spokespersons as saying that the SFRC calculation used overly unfavorable assumptions concerning unreported data that rendered its estimate of $20.9 billion in booked and unbooked losses between $7 billion and $10 billion too high (Day, 1989). This means that the FDIC would be comfortable with a procedure that adjusts the SFRC loss estimate to these lesser values. This revised calculation would indicate that the FDIC believes that its 1988 net reserve position may have been as small as $7.4 billion or as high as $10.4 billion. Both figures lie well below the official $14.1 billion measure of the size of the FDIC's deposit insurance fund contained in the FDIC's annual report. Even these more-favorable figures establish that FDIC resources are substantially smaller than its ordinary accounting system makes them appear and help to explain the wisdom of enacting a higher deposit-insurance premium for banks in 1989.

However, as this dispute makes clear, the procedures by which net reserves are calculated should be carried out in ways that are reproducible by other observers and employ the most pertinent and most complete set of information that the FDIC can compile. The FDIC's claim that SFRC assumptions overstate the corporation's loss rate in insolvency resolutions may have some merit, but the figures the FDIC suggests are based on an incomplete analysis of what costs are relevant. While the direct costs of insolvency resolution may indeed run around 10 to 12 percent of the assets of failed banks, the FDIC's indirect costs are much larger. Two papers prepared under FDIC auspices indicate that factoring in administrative and legal expenses raises the average loss rate to 30 to 33 percent (Bovenzi and Murton, 1988; James, 1989). Loss rates reported recently by FSLIC have been even higher. Moreover, none of the estimates in question allow for the additional indirect costs associated with the value of tax forgivenesses that were routinely conveyed to acquirers of insolvent institutions. In 1988, these "tax expenditures" included not only the opportunity to carry forward losses that had been experienced by an insolvent institution prior to its failure, but also a partial tax-exemption of assistance payments received from the FDIC.

At the window at which a traveller pays his or her bill for parking at most U.S. airports, management has posted a sign asking customers to notify them if the amount they pay differs from the amount displayed in big red lights by an electronic cash register. This request attempts to get customers to help managers to monitor the efficiency and honesty of their clerks. Your committee should see to it that outside experts and the financial press can similarly help Congress to monitor the accuracy and completeness of the estimates that federal insurers prepare for it.

Budgetary Implications of Net-Reserves Estimates

Net reserves is an insurer's balance-sheet "bottom-line," but it also has implications for the income statements of the insurance fund, its institutional clients, and the federal taxpayer that backs the system up. Whatever change develops in an insurer's net reserves during any fiscal year constitutes its annual deficit or surplus. When an insurer's net reserves are declining, it is operating in the red. Although an insurer's unbudgeted deficit or surplus is formally classified as an off-budget item, it deserves to be recorded as part of the annual federal budget and cumulated into the national debt. In a fully accountable framework the FDIC's promise earlier this year to honor insured banks' obligations in the swap market and Comptroller of the Currency Robert Clarke's proposal last week to revise the core-capital standard for national banks would each have been acompanied by estimates of the amounts by which these measures decreased the FDIC's net reserves and increased the budget deficit and national debt. One can draw a useful parallel between such estimates and the environmental impact statements that developers file to assess the environmental degradation their plans would entail.

Before August 9, 1989, some FDIC officials justified not acknowledging the FDIC's unfunded losses on the grounds that to do so might reduce depositor confidence in banks and stir up partial and unwarranted runs. Because the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 places the full faith and credit of the U.S. Treasury behind insured deposits, this justification no longer has any practical relevance. Weaknesses in the reconstituted FDIC Bank Insurance Fund (BIF) no longer expose insured depositors to a risk of loss.

However, changes in the strength of the BIF have become more clearly relevant for taxpayers. Such changes indicate whether the contribution that the general taxpayer must expect to make toward financing deposit-insurance guarantees is increasing or decreasing relative to the contribution of insured institutions. So that Congress can keep taxpayer's effective contribution under timely control, your subcommittee needs to press top FDIC officials to supply it and the communications media with regular updates of their best estimate of annual changes in the net reserve position of BIF and its companion Savings Association Insurance Fund (SAIF).

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APPENDIX

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Statement No. 36

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Statement of the Shadow Financial Regulatory Committee on The Need to Estimate the True Economic Condition of the FDIC

December 5, 1988

Based on information now available from the FDIC, a crude appraisal of the condition of the Federal Deposit Insurance Corporation can be made that takes account of the agency's unbooked losses. Using these data and simple assumptions, the Committee infers that, if the FDIC were to experience losses that would not be unreasonable to anticipate in view of its recent loss experience and problem bank estimates, the FDIC's reserve balance would be virtually exhausted at present.

The Committee's calculation makes use only of inadequate information publicly disclosed by the FDIC. The table attached to this statement estimates unbooked losses from three critical assumptions: the

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percentage of assets allocated to problem banks; projected bank failure rates; and a failure-resolution cost rate.

In light of the Committee's calculation, proposals to reduce the cost of recapitalizing the Federal Savings and Loan Insurance Corporation (FSLIC) by combining it with FDIC seem futile. Indeed, in a November 1988 report entitled The Financial Services Industry, the General Accounting Office reaches a similar conclusion:

> "While merging FSLIC with the healthier Federal Deposit Insurance Corporation (FDIC) has been suggested as a possibility, it would not solve the financial problems. The FDIC's reserves cannot cover the FSLIC losses. Moreover, problems in the commercial banks, especially those related to energy, real estate, agriculture, and third world lending, may require all of FDIC's present $18 billion of reserves." (p.6)

It is impossible for us to determine the accuracy of our crude estimate of the FDIC's net reserve position. To develop a more refined estimate, we urge the FDIC to release detailed information on the asset-size distribution of both problem-bank assets and failure-resolution cost rates.

Estimate of FDIC's Net Reserve Position on December 31, 1988

1. 1987 Yearend Data: FDIC-Insured Commercial Banks

	Number	Percentage	Projected Assets (in $Billions)[1]
Problem Banks	1,575	11.5	345.1
Nonproblem Banks	12,124	88.5	2,655.8
	13,699	100.0	3,000.9

2. Crude Calculation of Amount of Losses through December 31, 1988

	Problem Banks	Nonproblem Banks
Allocated Assets	$345.1 Bil.	$2,655.8 Bil.
Failure Rate[2]	.125	.01
Failure-Resolution Cost Rate[3]	.30	.30
Estimated Booked and Unbooked Losses	$ 12.9 Bil.	$ 8.0 Bil.

3. Calculation of Net FDIC Reserves on December 31, 1988

Deposit Insurance Fund on December 31, 1987	$18.3 Bil.
Income for 1988 (estimate)	3.0
Estimated Reserve before Booked and Unbooked losses as of December 31, 1988	21.3
Estimated Total FDIC Booked and Unbooked Losses	$20.9 Bil.
Net Reserve Balance	0.4

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[1] The FDIC does not provide data on the size

[Footnote continued from previous page] distribution of banks on its problem list. This analysis assumes that the size distribution of problem banks is similar to that of all banks. Since we know that several very large institutions have well-publicized weaknesses, we do not expect that this assumption leads to an overstatement of FDIC's potential losses.

[2] Over 1982-1987, the number of failures per year has averaged 14.1 percent of the number of problem banks identified going into the year. The median ratio is 13.6 percent, which our procedure rounds downward to 13.5. Because some "surprise" failures develop entirely within a calendar year, we treat roughly 7.5 percent of projected failures as developing outside of the population of banks identified as problems at the end of the previous year.

[3] The 30% loss figure was developed by J. Bovenzi and A. Murton in the FDIC Banking Review (Fall 1988), for a sample of relatively small banks that failed in 1985 and 1986. Evidence exists that FDIC's loss experience in handling large bank problems is substantially better. Thus, in resolving the First City (Texas), Continental Illinois and First RepublicBank (Texas) cases, FDIC's losses are expected to be less than 10%.

The CHAIRMAN. Thank you.

I want to make one comment, and then I will yield for Senator Heinz, to see if he has an opening comment.

Has anybody ever suggested that banks with higher capital levels, obviously honestly reported, should perhaps have higher deposit insurance levels, and banks with low real capital levels would then have lower insurance levels; so that you would actually tie the two together? Has anybody ever floated that idea?

Mr. KAUFMAN. I have not seen that idea specifically, but it would be a form of risk-sensitive insurance premiums.

The CHAIRMAN. It would also be a signal, it seems to me, to consumers, that if they are going out putting their money somewhere—there are several disciplines that would come out of that. One, it would be sort of a warning flag: low capital, you know, maybe this bank can only give you $25,000 of deposit insurance, and probably it would keep the big blocks of money away from the places where the capital is the least. Therefore, the risk is greater. But in any event, we can get to that.

Senator Heinz, did you have an opening comment to make?

Senator HEINZ. Mr. Chairman, I think we are in the midst of a very interesting discussion. I do have an opening statement. I ask unanimous consent that it be put in the record.

The CHAIRMAN. Without objection, so ordered. I also have an opening statement of Senator Dixon.

[Statements of Senators Heinz and Dixon follow:]

STATEMENT OF SENATOR HEINZ

Mr. Chairman, I join you in welcoming today's distinguished witnesses as we explore the health of our banking industry. Having just passed legislation to deal with dead and dying savings and loans, this is a good time to take the pulse of the more than 13,000 banks in our country.

After looking at the written testimony, it seems that some of today's witnesses are prepared to administer what may seem to many as shock treatment. Although the vital signs in 1988 have improved, we are being warned that the banking industry is far from a picture of health.

One of the main issues seems to be the reliability of our current diagnostic techniques—namely, GAAP—generally accepted accounting principles. Those principles don't appear to be well accepted by these witnesses. In their view, there are some big gaps in GAAP. They recommend that we examine market values before we give our banks a clean bill of health.

In a related vein, some of our witnesses warn that our banks are suffering from a capital deficiency—leaving them vulnerable to a chilly economic climate. They prescribe strong capital supplements and an adjustment of the minimum daily requirements. For many banks, this strong medicine may be hard to swallow.

Mr. Chairman, I look forward to today's examination. I am sure that we will want to get several opinions on the condition of bank operations. This is one area where the questions may not be answered with surgical precision.

STATEMENT OF SENATOR DIXON

Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee begins its series of hearings on the condition of the banking industry. I congratulate the chairman for scheduling these important hearings.

I also note with pleasure the excellent judgment showed by our chairman in inviting George Kaufman to testify. Professor Kaufman teaches courses on financial institutions at Loyola University of Chicago. He is a national leader in economics and banking and an innovative thinker on public policy issues. I also understand that he is as much a fan of the great city of Chicago as I am. Welcome to Washington, Professor Kaufman.

All of us are conscious of the example of the thrift industry. Fortunately, when we look at the banking industry there are at least two reasons for cautious optimism. Unlike the thrift industry, capital standards have been higher for banks. Second, the new thrift law raises insurance premiums for banks, even at a time when claims on the insurance fund are declining.

I look forward to the testimony of the academic and consulting experts today. I intend to listen carefully to any warnings they may offer. But I do believe that we can all draw some measure of confidence from the higher capital and premiums already present in the banking industry.

STATEMENT OF ROBERT E. LITAN, SENIOR FELLOW IN ECONOMICS, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. LITAN. I submit my written testimony, which was prepared in collaboration with Dan Brumbaugh. We have done a lot of academic work together. That is why we coauthored the testimony.

I want to discuss three issues: The importance of capital standards, the condition of the FDIC and the banking industry, and finally some suggestions for limiting risk to the FDIC.

Let me begin with capital standards. George has very succinctly pointed to their critical importance. Let me identify three important functions for you that they perform. First of course, they cushion the FDIC against loss. Second, good and well enforced capital standards discourage owners from excessive risk taking, owners of banks that is. Third—and it is not well recognized—but well enforced capital standards discourage the unscrupulous from even getting into the banking or thrift industry, and thus help guard against the kinds of fraud and so forth that apparently has been found in the thrift industry.

How high should capital standards be? This is almost a religious question. It is also arbitrary, because regulators and policy makers must balance two offsetting risks. On the one hand, if you are the insurer, you like capital standards to be real high. On the other hand, given the bias in the tax code which favors the issuance of debt over equity, capital could be costly to a bank, and a too high capital standard can actually make it uncompetitive.

Now, how do you balance these two offsetting considerations? I suggest that you look at table 1 in my testimony for some guidance. What table 1 does is to chart over time the equity to asset ratio for the U.S. banking industry.

Now, what is striking about this table is that you will notice in the 1960 to 1970 period bank capital ratios on average were 7 to 8 percent. This was during a decade that, compared with today, was relatively quiescent. We had a very long period of economic growth, and banks were heavily regulated.

Now in the 1980's, bank capital is in the range of 6 to 6½ percent. This decade, by comparison, is far more unstable. We have had a series of rolling recessions throughout the country, we have had major shocks to the energy market, to agriculture. We had deregulation. Banks have had a lot more competition. In short, you would think, just looking at these tables and comparing these two eras, you would say, "Well, how can it be that in the more stable era banks had more capital and today, in a less stable era, they have got less?"

In other words, it would strike you as backward. It strikes me as backward. The conclusion that I draw from this table and from other points in my testimony is that, at a minimum, we ought to be talking about 6 percent capital standards for banks, where capital would include in my opinion subordinated debt as well. George has written about and endorsed this concept. So take it at a minimum of 6 percent. There is good support for even raising it higher.

Now, how are we doing by this standard? Well, on average most of the banks are doing well, a least if you believe their officially reported accounting data. However, 2 weeks ago Dan and I testified before the House Financial Institutions Subcommittee, and we presented evidence based on a disaggregation of bank capital ratios, that in fact a sizeable minority of banks were either undercapitalized or insolvent.

We applied some conservative loss ratios that the FDIC could probably suffer, and we concluded that, as of the third quarter of 1988, the FDIC realistically had only about $4 billion of reserves, rather than $14 billion.

At that hearing, questions were raised about the recency of our data. The suggestion was made, that if we had used more recent data perhaps the numbers would be different. Table 2 answers those concerns. Table 2 updates our analysis through March 1989. The analysis is based on the new risk adjusted capital standards, which I will not describe in great detail, only for the largest banks, roughly 5,000 or so.

What you see there, if you look in the first column, is that the number of banks that are still insolvent—that is, with ratios below zero—is roughly the same as it was in September 1988. They have just about the same amount of assets. These are not the same banks, by the way; this is a different group of banks, because you have a downward escalator of banks falling off the edge through time.

Now, there has been some improvement in the zero-to-three percent category. You see that from September to March the volume of assets in that category fell from $45 billion to $9 billion. However, the reason why essentially most of that drop-off occurred was that a lot of the banks that were between zero and three in September are now insolvent. It is hard to draw a lot of comfort from the fact that we have had this downward escalator. I will return to that in a minute.

Finally, you will notice that in the three-to-six category we still have roughly 130 banks with almost $1 trillion in assets that are under-capitalized, at least by my definition and I think by most bank analysts' definition.

We believe these estimates are conservative, because they do not look to all banks, only the large banks. They also are based on conventional accounting data, not on market value data. In fact, we know from FDIC data, that there are over 1,000 problem banks currently in existence. We also know from Bill Ferguson's testimony 2 weeks ago before the House Financial Institution Subcommittee that there are roughly 450 banks operating today that have been losing money consistently every year since 1987. We do not even have all of the banks reflected in the table, so we think that our numbers are conservative.

But just to give you an idea about how significant phony accounting can be, turn to Table 3. Table 3 shows in the first column all of the banks in September 1988 that were weakly capitalized; that is, that had capital ratios of between zero and 3 percent—and that only 6 months later were gone, that is either were insolvent or closed.

Now, what is interesting about this table is to look at the deterioration between the positive levels that were reported in September 1988 and just 6 months later, how badly off some of these banks were. You will notice that in some cases the bank capital asset ratio fell by more than 20 percentage points, and some by 10 percentage points.

In other words, what this table tells you is that if a bank is reporting between zero and 3 percent capital, be real suspicious, because the fact of the matter is that a lot of those assets may be artificially inflated, and that very soon thereafter the bank could actually be insolvent, in fact may already be insolvent at the time that it is reporting zero to three percent capital-to-asset ratios.

It just reinforces the point that the Shadow Committee and others have made, that accounting data can be fictional and they can give you a false degree of comfort.

Turn to Table 4. What we have done there is to extend our analysis to all banks, not just the large 5,000 banks but to all 13,000 banks. Because of data limitations, we could not compute risk-adjusted capital standards, we had to use tangible capital, roughly speaking, and thus to make our calculations based on conventional accounting techniques.

There you see in the universe of all banks, we have got roughly $20 billion of assets as of March 31 being managed by insolvent institutions, and another $39 billion of assets being managed by weakly capitalized institutions.

If you apply the same kind of technique that we used a couple of weeks of ago and in our published work to estimate FDIC losses, you will find these asset figures represent a conservative loss exposure to the FDIC of about $10 billion, or virtually the exactly same number that we presented before the House 2 weeks ago.

The bottom line is, more recent data do not make any difference. The FDIC is weaker than officially reported, at least as of March 31, 1989.

Now, what should we do about this? I will tick off four key points. No. 1, I have mixed feelings about the risk-based standards, to be honest with you. On the one hand, I think it is very good that they are including off-balance sheet risks, but on the other hand, I am uncomfortable with the fact that we seem to be tied into the 4 and 8 percent numerical levels on an international basis. I would be comfortable with higher capital standards.

Second, I fully endorse what George Kaufman has suggested as a more mandatory system of early intervention, so that we stop these losses before they get worse.

Third, bank regulators have got to move toward more realistic accounting and thus toward market value accounting. They probably cannot do that immediately, but I have suggested in my testimony a halfway measure whereby at least banks could adjust their asset figures for fluctuations in interest rates, and report assets on a present discounted value basis, which is something that all banks could do even for loans that today are not currently traded.

Finally, I think the FDIC and the other bank regulators should report more information of greater use to you and to the public. Today, they report aggregate data on the condition of the banking industry as a whole. What they ought to be doing is something that the Thrift Office, ironically, has been doing for a couple of years and is well ahead of the bank regulators.

The thrift guys give you tables like our table 2 and table 4, where they break out how many banks are in the below-zero category, how many are between zero and three in terms of capital, between three and six, and above six. They tell you how many banks, what assets and so forth. Your committee, and frankly anyone, can then apply loss ratios to these various categories and compute some relative loss exposures to the FDIC. The Government ought to be doing that.

Finally, this suggestion dovetails with the requirement that is in FIRREA. There is a notice provision in FIRREA that requires the FDIC annually to report to you and to the House its loss exposure under various changes in economic conditions. I think it would behoove the FDIC to compute how sensitive the distribution of banks across capital categories actually is; to changes in GNP growth, changes in energy prices, agricultural prices and other economic conditions that can affect banks.

Thank you very much.

The CHAIRMAN. Very good. Thank you.

[The complete prepared statement of Robert E. Litan follows:]

Prepared Joint Testimony
of
R. Dan Brumbaugh, Jr. and Robert E. Litan[1]

before the
Senate Committee on Banking, Housing and Urban Affairs

October 5, 1989

Thank you Mr. Chairman for the invitation to appear before you today to respond your questions about the condition of the commercial banking industry in the U.S. In brief, we conclude that while the banking industry is generally sound, the sizeable number of insolvent and marginal banks now operating indicate that the reserves in the bank insurance fund within the FDIC are less substantial than official reports indicate. In addition, while banking regulators thus far have performed well in discharging their supervisory responsibilties, the FDIC's additional responsiblities under the recently enacted thrift legislation could weaken that agency's supervisory resources. We believe that the dangers to the insurance fund are best minimized by a combination of tougher capital standards, improved accounting, and earlier intervention by regulators before banks and thrifts actually become insolvent.

Importance of Bank Capital

Before turning to the first question posed by the Committee -- the sufficiency of current capital in the banking system -- it is useful to provide some background to the capital issue since it is perhaps the most important topic for those interested in and concerned about the condition of the FDIC and the banking system as a whole.

As the recent thrift crisis teaches, capital in depository institutions performs three critical functions. It protects the insurer by requiring that bank and thrift shareholders be the first to suffer losses. Capital also deters excessive risk-taking: owners with significant amounts of their own money at stake are less likely to tolerate managers who gamble with insured deposits than those owners with little or nothing to lose and everything to gain from letting bank managers roll the dice (at the FDIC's expense). And finally, well enforced capital standards discourage the unscrupulous from entering the banking business.

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In 1981, for the first time the three federal banking agencies (the FDIC, the Federal Reserve Board and the Comptroller of the Currency) announced specific capital guidelines for community and regional banks. Two years later, Congress directed the agencies to set capital standards for all banks. By 1985 all of the agencies had responded with common standards, which require all banks to maintain "total capital" -- shareholders' equity, subordinated debt and loan loss reserves -- equal to at least 6% of their assets.

The bank agencies have since negotiated an additional "risk-adjusted" system of capital standards with representatives from 11 other leading industrialized countries. Commonly referred to as the "Basle" standards (named after the Swiss city in which they were developed), these new standards define two minimum capital-to-asset ratios, with assets of greater variability assigned greater risk weights.[2] Significantly, for the first time off-balance sheet liabilities -- including letters of credit and various types of financial guarantees and exposures -- are included in the asset base with appropriate risk-weights. By 1993 banks must have primary ("Tier I") capital or shareholder's equity (common and preferred stock and retained earnings) equal to 4% of their risk-adjusted assets; and secondary ("Tier II") capital, consisting of primary capital plus subordinated debt and loan reserves and other minor items, equal to 8% of risk-adjusted assets.

With the risk-adjusted standards about to become effective, a concern has arisen that by investing heavily in assets with less than 100% risk weights -- such as government securities and mortgages -- a bank could meet the risk-adjusted capital standards but nevertheless end up with relatively low conventional (non risk-adjusted) capital-to-asset ratios. Thus, for example, a bank (or thrift) that hypothetically invested all of its funds in mortgages, which are given a 50% risk weight, and had no off-balance sheet commitments would in effect be permitted under the Basle standards to hold Tier I capital of as little as 2% of total (non risk-weighted) assets. A bank with 100% of its funds in Treasury bills, which have a 0 risk weight, would be required to maintain no capital at all.

Accordingly, the FDIC and Comptroller have been debating over the past several weeks how to revise the previous (1985) conventional capital standards to provide a floor below the risk-adjusted guidelines; or to put it another way, to establish an updated non risk-weighted system of capital regulation. The issue has acquired some urgency given instructions in the recently enacted thrift legislation -- the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) -- that by early January 1990 the new

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[2] The Basle standards, however, do not take account of several other types of banking risk -- including risks from changes in interest rates, potential deposit volatility, and different portfolio mixes.

Office of Thrift Supervision set capital standards for thrifts that are "equivalent" to those for banks.

The Comptroller thus has proposed a new 3% "tangible" capital-to-asset ratio, with eligible capital restricted to shareholders' equity, a definition analogous to the Tier I risk-adjusted standard. Not coincidentally, the 3% tangible test is identical to the minimum standard set for thrifts, effective by 1994, in FIRREA. The FDIC, however, apparently, has been insisting on a supplemental capital standard -- beyond a 3% tangible capital rule -- that perhaps would be analagous to Tier II capital in the risk-adjusted system.

The regulators' debate over appropriate capital standards understandably has been confusing to the public, and perhaps to you in Congress as well. The debate involves different definitions of both capital and assets and thus makes it difficult to compare "capital-to-asset" ratios under different schemes.

The debate also highlights the difficulty -- and indeed arbitrariness -- involved in answering the critical question: "How much capital is enough?" As for most other public policy issues, answering this question requires balancing several objectives. On the one hand, more capital is always better from the insurer's perspective. On the other hand, higher capital requirements constrain the ability of depository institutions to grow -- i.e. to attract deposits -- and thus to provide valuable intermediation services (investing deposits in loans). In addition, because interest is deductible for tax purposes but dividends are not, higher capital requirements can be costly to banks and thus potentially impair their competitive viability.

Different people will strike this balance at different points; there are no clear hard and fast rules. However, two reasons stand out for taking a conservative -- or tough -- approach to capital standards, at this particular time especially.

First, as shown in Table 1, it is somewhat ironic that although it is has increased in recent years, the average capital-to-asset ratio for the banking industry in the 1980's -- roughly 6% -- has remained below the 7-8% levels of the 1960's. The comparison is ironic because the 1960's were an era when bank deposit rates were heavily regulated and when the economy enjoyed a relatively smooth and long economic expansion; in contrast, the 1980's have been marked by deposit interest rate deregulation and a series of economic shocks -- the 1981-82 recession, the collapse of energy prices, the LDC debt crisis, turmoil in agricultural markets -- in short, substantially greater economic instability. Indeed, some economists have characterized the 1980's as a period of overall growth but "rolling recessions" through different parts of the country. On these facts alone, one would prefer to have banks now better capitalized than in earlier years when they were exposed to less competitive pressure and to fewer economic shocks.

Second, the thrift crisis has brought home to the public and to the Congress the dangers of thin (or non-existent) capital standards. Given the hundreds of billions of dollars (counting principal and interest) that eventually will be thrown at the thrift problem it seems a small price to pay to ask of banks and thrifts that they meet stiff capital requirements.

Given these considerations, where does one draw the line? In our analysis, we have used a 6% capital benchmark -- where capital includes both shareholders equity and subordinated debt, but not loan loss reserves. As a number of economists have pointed out, subordinated debt deserves to be treated as a capital since, unlike a deposit, it cannot be redeemed on demand and is subordinate to the deposit insurer. Meanwhile, loan loss reserves clearly should not be counted since these represent earmarkings for losses likely to be recognized in the future and thus provide no protection to the FDIC against possible future losses. We choose 6% as a minimum figure since that is the average for the banking industry already. Moreover, given the riskier environment in which banks operate today, any lower capital level would be imprudent.

Sufficiency of Bank Capital

By the standard just given, the banking industry as a whole appears healthy. The latest FDIC figures show that through the first half of 1989 the average bank capital-to-asset ratio was 6.4%.

The FDIC, however, cares less about average bank performance than about those banks at the "bottom of the barrel", or in statistical jargon, those at the poorly performing "tail" of the distribution. For it is only the banks that fail that require the FDIC to suffer a loss, either in paying off depositors or assisting the acquisition of a failed bank by a healthier partner.

During the past year, a number of private analysts have suggested that when unrecognized but already incurred losses from bank failures are taken into account, the FDIC actually has been less healthy than officially reported -- a pattern that echoes what happened with the FSLIC several years back. We offered this assessment 14 months ago in The New York Times (August 21, 1988), attached as Appendix A. In December 1988 the Shadow Financial Regulatory Committee reached a similar conclusion.

We have since updated our previous work and presented it to a hearing of the Financial Institutions Subcommittee of the House Banking Committee on September 19, 1989. Our analysis reflects calculations of the capital positions of roughly 5,500 of the nation's largest banks, or those with assets of at least $50 million.[3] Our calculations were based on the Basle risk-adjusted capital guidelines, using the definition of capital we have just advanced: shareholder's equity (common, preferred and retained earnings) and subordinated debt, with loan loss reserves excluded. Given the constraints of available data, we were able to present results at that time through the third quarter of 1988.

Briefly, that analysis showed that 28 large banks with nearly $23 billion in assets were still open and insolvent on September 30, 1988. Another 48 institutions holding $43 billion in assets had risk-adjusted capital ratios below 3%. And still another 150 banks with assets totaling $926 billion had capital ratios between 3% and 6%. In short, roughly $1 trillion of assets -- or 1/3 of the assets in the nation's banking system -- were being managed as of September 1988 by banks with sub-standard capital ratios.

We concluded from this analysis that, conservatively speaking, the FDIC's actual reserves at year end 1988 were closer to $4 billion than the official figure of $14.3 billion. We reached that conclusion as follows:

--During the 1980's the FDIC has averaged a loss of 26 cents on the dollar on failed banks. Applying that ratio to the $23 billion in assets of failed banks yielded a future expected loss on those banks of $6 billion.

--As we will discuss shortly, experience has shown that once a bank is reporting capital below 3% of assets there is a reasonable likelihood that it will become insolvent. Applying a conservative expected loss ratio for the $43 billion of banks in the 0-3% capital category suggests an additional expected future loss of $4.3 billion.

--Adding the additional losses in both these categories yields a figure of $10.3 billion, which when subtracted from the official year-end 1988 reserve figure of $14.3 billion, produces a more realistic reserve estimate of $4 billion.

Questions were raised at the Committee hearing about the reliability of our results with more recent data. We answer these questions in Table 2, which updates our previous calculations through the first quarter of 1989.[4]

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[3] The original analysis on which the House testimony was based can be found in R. Dan Brumbaugh, Jr., Andrew S. Carron and Robert E. Litan, "Cleaning Up The Depository Institutions Mess", Brookings Papers on Economic Activity, 1989:1, pp. 243-83. The Committee's staff has been provided copies of this study.

[4] The figures in Table 2 for pre-1989 quarters differ slightly from our earlier calculations for two reasons. The revised calculations include a few additional newly chartered banks in each quarter that were not

Table 2 illustrates that the number of open but insolvent banks and their assets remained essentially unchanged from the third quarter of 1988 (31 banks with $22.9 billion in assets) to the first quarter of 1989 (31 banks with $22.1 billion in assets).[5] Generally, this was not because the same banks continued to be insolvent but rather because previously solvent banks fell into insolvency.

It is true that the number and assets of weakly solvent banks -- those with risk-adjusted capital-to-asset ratios between 0 and 3% -- have fallen since the third quarter of 1988. Significantly, however, this was largely because many banks that were barely solvent in the earlier period fell into insolvency by March 1989. This movement underscores the danger of relying on accounting data based on historical cost rather than market values, a point which we discuss shortly.

Still, however, based on the same analytical procedures used earlier, the results through the first quarter of 1989 suggest that the FDIC's bank insurance fund continues to be weaker than reported -- by roughly $7 billion rather than $10 billion.

We want to stress that this calculation is conservative because it is based only on the nation's largest 5,500 banks. In fact, however, the FDIC itself acknowledges that there are many more banks on its "problem list", consisting of banks that receive one of the two poorest ratings from bank examiners. As of the second quarter of 1989, the problem bank total stood at 1256, a figure down from its 1987 peak of 1557 but one that is still more than three times the previous post-war peak year of 1976 (385) and more than six times as many as in 1981, when the nation was entering its deepest recession since the 1930's. Significantly, in his September 20, 1989 testimony before the House Financial Institutions Subcommitee, Professor Ed Kane of Ohio State noted that between 1982 and 1987 approximately 14% of the problem banks going into any year eventually became insolvent.

In addition, our figures are based on historical cost accounting which has proven time and again to be misleading about the extent of bank losses,

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previously included. In addition, the new calculations use a 50% risk weight for mortgages, whereas the earlier calculations reflected a 100% risk weight for these assets. The differences in assumptions have only a minor effect on the overall conclusions.

[5] Our results are roughly consistent with calculations made by Veribanc, Inc. which showed that 39 national banks with assets of $16.7 billion would be insolvent if, as the Comptroller has proposed, loan loss reserves are excluded from the definition of primary capital. See American Banker, March 3, 1989.

especially among officially "weakly capitalized" banks that in reality already are insolvent when their assets are valued at market. This is dramatically demonstrated in Table 3, which shows the risk-adjusted capital ratios of the 16 "weakly capitalized" banks in the third quarter of 1988 that were insolvent by March 1989. The fact of their insolvency is not as important as the extent of their deterioration: in some cases, reported capital-to-asset ratios fell by more than 15 percentage points in just two quarters!

Fictitious accounting, of course, explains this pattern. If a bank is reporting capital levels close to insolvency, the chances are that many of its loans are overstated: once it crosses the line into reported insolvency honesty is easier to come by or is forced upon the bank by the regulators. In either case, however, Table 3 highlights how misleading reported book values can be, especially for institutions that report themselves as weakly capitalized.

Nevertheless, again in the interest of conservatively estimating FDIC's loss exposure, we have used reported book values to calculate ratios of shareholders equity to assets for all commercial banks (without assigning risk weights to assets or including off-balance sheet commitments, as under the risk-based system), as of the first quarter 1989. The results reported in Table 4 tell essentially the same story as in Table 2: 90 banks with $20 billion in assets were open and insolvent as of March 1989 and another 196 banks with nearly $39 billion in assets were weakly capitalized. Using these figures and the same costing methodology described earlier, the unrecognized losses of the FDIC as of the first quarter of 1989 stood at $9.5 billion, or virtually the same level as we had calculated from a narrower data base through September 1988.[6]

Table 5 illustrates that the insolvency problem is concentrated overwhelmingly in Texas and other Southwestern states. This is somewhat less true for weakly capitalized banks; indeed over half of the assets in these group are held by banks located outside Texas.

In short, no matter how you look at it, more recent data do not change the basic message: the FDIC is weaker than officially reported. We are not alone in advancing this message; indeed our calculations appear conservative. The day after we testified before the House Financial Institutions Subcommittee, bank and thrift analyst William Ferguson projected potential unrecognized losses to the FDIC as of the first quarter of 1989 of $13-$14 billion. And Professor Kane, who issued warnings many years ago about problems in the deposit insurance system, estimated the

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[6] At a 26% loss ratio, the $20 billion of assets in insolvent banks projects to $5.6 billion of losses; and the $39 billion of assets in weakly capitalized banks translates into projected losses of $3.9 billion.

FDIC's net reserve balance at year end 1988 at barely above 0, or just $400 million.

Reliability of Bank Earnings Reports

The reported dramatic recovery of earnings in the banking industry is now well known. After plunging in 1987 due to sizeable additions to loan loss reserves, bank profits hit a record $25.3 billion in 1988. This year, the prospects look even better, with profits through the first half hitting $14.3 billion, putting the industry's profits on a $28 billion-plus pace.

But just as aggregate data on banking industry capital conceal the minority of banks that are weakly capitalized or insolvent, so too do the aggregate profit data conceal the significant number of banks that are losing money. For example, through the first half of this year, 9.7% of all banks -- or roughly 1250 institutions -- lost money. More disturbing is the number of banks that consistently have been unprofitable. In his testimony before the House Financial Institutions Subcommittee, William Ferguson highlighted 443 banks with $35 billion in assets that have been operating in the red since 1987; and another 176 banks with $20 billion in assets that have been doing so since 1988. Ferguson's estimate of the FDIC's potential loss exposure of $13-14 billion is based on an expected loss equal to 25% of the assets in these two bank groupings.

Concerns About Portfolio Composition

The American banking industry -- and indeed the financial services industry -- has changed radically in the 1980's, in ways too numerous to discuss here. However, one particular change that is worth highlighting for the Committee's present purpose is the increasing "securitization" of finance. By packaging large pools of loans -- at first mortgages, and then, consumer loans -- into securities, Wall Street has revolutionized finance by broadening the investment instruments available for purchase by non-depository institutions (insurance companies, pension funds and mutual funds) and individuals. In addition, high-quality corporate borrowers have deserted banks as sources as funds for the cheaper securities markets (through the issue of commercial paper and corporate bonds).

This "securitization" movement has had a major effect on both banks and thrifts. The flight of high-quality corporate borrowers to the securities markets has forced banks to lend to higher-risk customers. This trend has been reinforced by the explosion of the asset-backed securities markets, which by narrowing the "spreads" depositories traditionally earned between the interest rates paid their depositors and the rates charged their borrowers, have driven depositories to make loans that are not so easily securitized and thus characterized by larger risks.

The effect of securitization is reflected in the composition of the loan portfolios of banks. As shown in Table 6, since 1980 bank loan portfolios have increasingly shifted toward real estate loans and away from the traditional commercial and industrial (C&I) loan market. Indeed, in many states the typical bank has over 40% of its total loan portfolio devoted to real estate lending, as shown in Table 7. Indeed, it is fair to say that in these states banks therefore increasingly are looking like thrifts -- and thus taking on the interest rate risk traditionally associated with thrift lending (borrowing "short" and lending "long").

Moreover, in most of these states, real estate lending primarily consists of commercial real estate loans, which as the thrift crisis has demonstrated, also carry substantial credit risks. Banks in the New England states have recently learned this lesson. Largely because of problem real estate loans, in the first half of 1989 the ratio of nonperforming assets to total assets for banks in this region jumped over 2.5%, substantially above the 1.6% recorded in 1986.[7] Just three days ago (October 2, 1989), the Bank of Boston announced a major addition of $370 million to its loan loss reserves due, in substantial part, to nonperforming real estate loans.

Meanwhile, within the C&I loan category, loans for leveraged buyouts (LBOs) have become increasingly important. Virtually unknown at the beginning of the decade, merger-related loans (of which approximately 80% are LBO loans) accounted for 11.5% of the C&I loan portfolios of the 60 largest domestically chartered banks at year-end 1988 (but down somewhat from 15% the year earlier).[8] At some major banks, the LBO loan has more than filled the shoes of the LDC loan. As shown in Table 8, in at least 5 major banks LBO loans equalled more than 100% of bank equity as of June 30, 1989.

When properly diversified, both real estate and LBO lending can be both profitable and safe. But the rising trends toward loans of both types reflects fundamental forces in finance that are driving banks to make individual loans of higher risk than in earlier periods when borrowers had fewer choices about where to get financed. As a result, regulators and examiners must exercise a greater degree of vigilance to ensure proper diversification and thus prevent banks from exposing themselves and the FDIC to excessive risk. This burden is especially great when a significant number of banks are weakly capitalized.

Adequacy of Supervision, Examination and Enforcement

To date, the generally high quality of bank examination and supervision -- at both the federal and state levels -- has kept problems in the banking industry confined to a relatively small number of institutions.

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[7] The FDIC Quarterly Banking Profile, Second Quarter 1989.

[8] "Recent Developments in the Profitability and Lending Practicies of Commercial Banks", Federal Reserve Bulletin, July 1989, p. 464.

However, the thinness of the FDIC's reserve position demands an extra degree of vigilance in the months and years ahead. And it is in this context that we express some concern about the tremendous burden under which the FDIC, in particular, has been required to operate now that it has also assumed substantial new burdens in handling the thrift cleanup.

Specifically, we refer to the fact that only several weeks ago the FDIC transferred 600 employees to the Resolution Trust Corporation to deal with thrift failures.[9] This transfer involves approximately 9% of all employees in the FDIC's divisions of bank supervision (responsible for examinations) and liquidation (responsible for disposition of failed banks' assets), the two divisions most directly affected.[10] Yet the impact is even more significant. As recently as 1985, approximately 35% of the FDIC's liquidation employees were temporary hires at failed banks. If this proportion remains today (a fact we have been unable to confirm), then the recent employee transfer may involve a substantially greater proportion of total permanent FDIC liquidation and supervision personnel.

Diluting crucial FDIC staff at this time is ominous. Significantly, the recent transfer exceeds the misguided 8% reduction in federal thrift examiners between 1978 and 1984 (from 651 to 596), a mistake that contributed to the thrift crisis.

To the agency's credit, the FDIC has recently announced the addition of substantial numbers of new examiners to its staff. While the new personnel are to be welcomed, this Committee nevertheless should realize that the training of bank examiners is a time-consuming process. Often, an examiner is not really well-trained -- to the point of being able to spot concealed dangers in a bank -- for several years. Under these circumstances, the FDIC -- and conceivably the Comptroller as well -- faces a "window of vulnerability" in the years ahead when still sizeable numbers of under-capitalized banks with substantial assets will continue to be operating with incentives to take risks at the FDIC's expense.

Forecast For The Industry

As long as the economy continues to perform well, we expect that in the aggregate the banking industry will continue to perform reasonably well. However, we also continue to be concerned about the significant minority of banks that continue to operate in an insolvent condition or that are weakly capitalized and have strong incentives to gamble at the FDIC's expense.

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[9] New York Times, August 28, 1989, p. C2.

[10] Employment data are from the FDIC's Annual Reports, 1985-87.

Past experience certainly is far from comforting. At year end 1988, official FDIC reserves of $14.3 billion were below the $15.4 billion level at year end 1984 -- meaning that, taken collectively, the FDIC lost money during the past four years. Significantly, these were years of economic expansion in which the economy grew at an average rate of 3.3%. This experience suggests that even if the economy should continue to grow without negative interruptions, significant turmoil among banks is to be expected.

Still, it is conceivable that despite its relatively thin reserve position now the FDIC could "grow its way back" toward a sounder position. The increase in premiums should shortly add roughly another $1.5 billion per year to the agency's revenues, an amount that had it been available during the past 4 years, would have allowed the insurer to report a net gain rather than a net loss in reserves.

At the same time, however, the future is full of uncertainty -- and any one of a number of macroeconomic events could shatter any optimistic forecast. Moreover, whether the FDIC can continue to remain solvent under the current premium structure will depend largely on the performance of the banks now operating with sub-standard capital ratios, or 3%-6% on a risk-adjusted basis. Table 2 indicates that roughly 130-150 banks with assets over $50 million have been in this group since year end 1987 and that these banks hold over $900 billion in assets. If all banks are counted and capital ratios are computed on a non-risk adjusted basis without counting off-balance sheet commitments, then Table 4 indicates that nearly 1,400 banks with almost $1.5 trillion in assets fall in this category.

We single out these undercapitalized banks for concern since these institutions will continue to be tempted to take risks at the expense of the insurance fund as long as they are permitted to operate with relatively thin capital margins. In addition, many of the banks in this group -- especially the larger ones -- are reporting capital positions based on conventional accounting techniques that overstate the value of certain assets, notably LDC debt. This continues to be the case even after the welcome addition to LDC debt reserves and plans for additional capital announced recently by several major money center banks.

For example, taking into account both the additional reserves and planned increases in capital, by year end the equity-to-asset ratio at Chase Manhattan will be 3.7%; at Manufacturers Hanover 4.7%; and at Morgan Guaranty below 5% -- all levels below our suggested 6% minimum.[11] In addition, among the top 15 banks, only First Chicago, Morgan, Security Pacific and Wells Fargo have raised their LDC debt reserves above 50%, the reserve level established on average by regional American banks and major British banks (many European banks are at 75% and above). Outside of Chase and Manufacturers, the other major money center banks that have not raised their reserves still have risk-adjusted capital ratios in the 3%-4% range; these ratios would be even lower with more realistic statements of LDC reserves.[12]

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[11] See American Banker, September 25, 1989, p. 21.

Recommendations for Regulators

Several steps can be taken by regulators, perhaps supported in specific cases by legislation, to reduce the FDIC's exposure to future banking losses.

First, the current capital standards should be strengthened. The Comptroller has advanced two proposals that improve upon the current system: (1) for enforcement purposes, capital will no longer include loan loss reserves, meaning that banks without shareholders equity will be closed; and (2) a new tangible capital-to-asset ratio of 3% will apply for all national banks. As we have already indicated, however, there is a strong case for doing more.

Banks today face greater risks than they did in earlier periods. Moreover, capital ratios based on conventional accounting data can be highly misleading. As we pointed out in Table 3, a number of banks reporting positive risk-adjusted capital ratios of nearly 3% in September 1988 had either failed or were deemed insolvent just six months later.

Accordingly, as long as bank capital standards continue to rest on historical cost accounting data, or Generally Accpeted Accouting Principles ("GAAP"), we believe it is prudent for banks to maintain capital of at least 6% of assets. We would permit subordinated debt to meet up to half this level. We suspect that for many banks such a standard would be no more stringent than the risk-adjusted standards, but also recognize that for many the risk-adjusted standards could no longer be relevant. This shouldn't matter. The safety of our banking system and the FDIC are too important to be compromised over potential inconsistencies with the risk-adjusted capital system.

In fact, an excellent case can be for an even higher standard than 6% (while permitting subordinated debt to qualify as capital) in light of the increased risks to banks in recent years posed by uneven economic performance and to a more broadly deregulated environment. Thus, Professor Paul Horvitz of the University of Houston has urged a 9% standard.[13] And

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[12] See Brumbaugh, et al., "Cleaning Up The Depository Institutions Mess", at p. 254.

[13] "More Is Better as Far as Capital Requirements Go", American Banker, April 24, 1986 (p. 4).

Professors George Benston (of Emory University) and George Kaufman (of Loyola University of Chicago) have supported a 10% standard.[14]

Second, we believe regulators should begin the process of requiring banks to report their financial condition on a more realistic basis. Eventually, we would like to see all banks mark their asset and liabilities to market. We recognize, however, that market-value accounting cannot be readily implemented because banks invest heavily in non-traded assets (many loans). Nevertheless, the perfect should not be the enemy of the good. In the meantime, regulators can begin to require banks to report their assets on a present discounted value basis, that is with cash flows discounted at the banks' cost of funds.[15] Under such a system, the regulators can observe how the banks' capital varies with movements in interest rates.

Third, banking regulators should take a cue from the economists at the Office of Thrift Supervision ("OTS")and begin to publish disaggregated data for the banking industry. Each quarter the OTS publishes a table analogous to our Table 2, or information indicating the number of thrifts and their total assets in each of several capital categories (both GAAP and tangible capital). The banking industry should be required to do the same, using both the risk-adjusted capital guidelines and final non-risk-weighted standards that the FDIC and Comptroller eventually agree upon. Such information would enable the public more readily to calculate the current exposure of the FDIC's bank fund to unrecognized losses already incurred.

Fourth, in a little noticed provision of FIRREA (Section 220), Congress has directed the FDIC also to report each January (beginning in 1990) not only the current condition of the bank and thrift insurance funds, but also the exposure of each fund to "changes in those economic factors most likely to affect" their condition. If the FDIC fulfills this mandate -- an outcome your Committee can help ensure through its oversight of the FDIC -- the agency should report the sensitivity of the funds' balances to changes in, among other things, interest rates, economic growth, and perhaps in prices of key commodities (like agricultural goods and oil). Such information should indicate, for the first time, whether the funds are adequate in the event of occurrences that can be reasonably anticipated. If not, the Congress may want to reconsider the premium structure for deposit insurance at the time it considers reform of the deposit insurance system. Incidentally, we believe the only way the FDIC can faithfully carry out the FIRREA mandate is to move in the direction of mark-to-market accounting, as we have just suggested.

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[14] "Regulating Bank Safety and Performance", in William S. Haraf and Rose Marie Kushmeider, eds., Restructuring Banking & Financial Services in America (American Enterprise Institute, 1988), pp. 63-99.

[15] For a discussion of this procedure see the article in the American Banker (September 29, 1989) by Ernest Fleischer and Robert E. Litan, attached as Appendix B.

Finally, as a number of analysts have recommended, the regulators should alter their enforcement procedures to adopt "earlier intervention" policies. By this we mean automatic suspension of dividends and growth limits for moderately undercapitalized institutions, and mandatory conservatorships for significantly undercapitalized but still solvent institutions. In the latter case, if shareholders will not provide additional capital, then the bank or thrift should be auctioned off to bidders who will meet capital standards (with any proceeds of the auction given to the old shareholders).

Forum

APPENDIX A

INSURING THE INSURERS

The Banks Are in Big Trouble, Too

By R. DAN BRUMBAUGH Jr.
and ROBERT E. LITAN

THE sad plight of the savings industry has recently become front-page news. Outside observers have pegged the cost of liquidating or forcing the merger of insolvent savings institutions at $50 billion, or more — well above the roughly $20 billion available to the industry's deposit insurer, the Federal Savings and Loan Insurance Corporation, through 1990. Slowly but surely the American people and Congress are beginning to realize that taxpayers will be tapped to pay F.S.L.I.C. insured depositors at insolvent savings institutions.

In the hope of forestalling this outcome, some have suggested that the beleaguered F.S.L.I.C. be merged with its much healthier banking counterpart, the Federal Deposit Insurance Corporation. On the surface, a merger looks attractive. The F.D.I.C. began 1988 with about $18 billion in reserves and annual income from premium assessments of $3.3 billion.

But appearances are deceiving. The data for the banking industry we have examined indicate that the F.D.I.C. may soon be unable to fund the cost of closing all insolvent banks. The F.D.I.C. is on its way to joining the F.S.L.I.C. in bankruptcy.

Specifically, we have estimated (with the assistance of the financial institutions group at Drexel Burnham Lambert Inc.) the capital ratios of all commercial banks with more than $50 million in assets.

We have designed our capital ratios to measure the cushion that bank capital actually provides the F.D.I.C. and to exclude what is worthless to the F.D.I.C. in the event that a bank becomes insolvent.

The accompanying table tells a disturbing story. The number of open banks with no capital — institutions posing the greatest threat to the F.D.I.C. — grew from 2 to 15 from the end of 1986 through the end of 1987. The total balance sheet assets in these insolvent institutions exploded from just $200 million to $5.1 billion. Even more alarming, banks with relatively little capital — above zero but less than or equal to 3 percent — grew from 20 to 42, with asset growth from $8.8 billion to $88.9 billion.

The Banking System's Capital Base

Estimated net worth of U.S. commercial banks with more than $50 million in assets.

	Fourth Quarter 1986		Fourth Quarter 1987	
Banks with capital/ —	Number of Banks	Assets (in billions)	Number of Banks	Assets (in billions)
less than assets	2	$0.2	15	$5.1
0 to 3% of assets	20	$8.8	42	$88.4
3% to 6% of assets	116	$296.9	164	$918.0
6% or more of assets	5,239	$1,762.3	5,229	$1,771.8

Source: Author's calculations, with assistance from the Financial Institutions Group at Drexel Burnham Lambert Inc.

The F.D.I.C. is on its way to joining the F.S.L.I.C in bankruptcy.

Unfortunately, the available data extend only through the fourth quarter of 1987, which means the problems illustrated in the table are understated. The First Republicbank Corporation in Dallas, with $19 billion in assets, was included in the poorly capitalized, but solvent, group of banks in December 1987. This bank is now being taken over, with $4 billion in F.D.I.C. assistance, by the NCNB Corporation. If First Republicbank is included in the "no capital category," then roughly $24 billion in bank assets are located in insolvent institutions.

How much will these banks alone cost the F.D.I.C.? Over the past two years, it has cost the agency about 30 cents on the dollar (of assets) to close insolvent banks. On this basis, banks that the F.D.I.C. should know to be insolvent will cost the agency at least $7.2 billion.

But the problems facing the F.D.I.C. are likely to be even worse. The available capital data are based on "generally accepted accounting principles," which tend to overstate the net worth of troubled banks. It is almost surely the case, for example, that the reserves set aside for third world debt by many of the money center banks are still insufficient. And certain banks are overstating the value of their troubled domestic real estate. Indeed, the fact that First Republicbank was reporting 2.7 percent of risk adjusted capital at year-end 1987, by our calculations, suggests that the true capital for many banks is less than we estimated.

If this is the case, then the F.D.I.C.'s reserves of $18 billion may already be obligated to pay for troubled banks that are already insolvent or likely to become insolvent. The already rapid deterioration would be even worse if the economy dips into recession. Clearly, merging the F.D.I.C. with the F.S.L.I.C. will not solve the saving industry's problems because the F.D.I.C. is already much weaker than its officials have publicly acknowledged.

What else can done? One approach is to assess banks and savings institutions additional deposit insurance premiums. The chairman of the saving industry's Federal regulator, the Federal Home Loan Bank Board, has suggested that the supplemental premium of 12.5 basis points on each dollar of deposits already imposed on savings and loans be extended through 1998. There will doubtless be suggestions that banks, too, pay this extra premium.

WHILE making healthy banks and savings institutions pay for part of cleaning up the problems in their industries may be politically necessary, it can't be the only answer. The problems among depository institutions are simply too great. And to wait for 10 more years to solve them — while the extra premium dollars flow in — would be a dangerous mistake.

In short, substantial general revenues are absolutely essential to a quick resolution of the problems in the bank and savings industries. And quick it must be.

The longer insolvent banks and savings associations are permitted to operate, the greater the risks they will take in the false hope of returning to solvency. History proves clearly that in taking these risks, insolvent and near-insolvent institutions tend to become weaker over time, not stronger. In addition, in order to stay liquid, insolvent and poorly capitalized institutions offer high interest rates on their deposits, bidding up the cost of deposit funds for healthier institutions and thus weakening the entire industry.

The sooner insolvent banks and savings institutions are put out of their misery, the better off the financial system will be and the lower the ultimate cost of taking care of the problem. We estimate that the higher savings interest rate payments and the special insurance assessment are costing the industry $10 billion annually and will produce future failures.

Fortunately, tackling the savings and bank problem quickly is not only the right economic approach, but it has political attractions for the next Administration. If all the costs are front-loaded — say $30 billion in fiscal year 1989 — the budget deficit would rise substantially in only one year but then fall dramatically thereafter. Both the President and Congress could then take credit for the tremendous improvement as the nation heads into its mid-term elections in the fall of 1990. ■

R. Dan Brumbaugh, a consultant, is author of "Thrifts Under Siege: Restoring Order to American Banking." Robert E. Litan, a Senior Fellow at the Brookings Institution, is author of "What Should Banks Do?"

4 American Banker September 29, 1989

COMMENT

APPENDIX B

Some Hidden Nuggets in the Thrift Bill

By ERNEST FLEISCHER
and ROBERT E. LITAN

BURIED deep within the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 are some obscure provisions that could eventually revolutionize – in a highly salutary fashion – the way our depository institutions report their financial condition and the methods by which our regulators watch over them.

Section 220 of the act requires the Federal Deposit Insurance Corp. to report to Congress each January, beginning in 1990, on the "financial condition" of the thrift and bank insurance funds, as well as the current exposure of each fund to "changes in those economic factors most likely to affect" their condition.

Section 1218 directs the Federal Financial Institutions Examinations Council to develop and administer training seminars in risk management for bank and thrift employees and to report to Congress by next year on the feasibility of certifying expertise in risk management analysis.

Finally, Section 1001 requires that the Secretary of the Treasury report to Congress within 18 months on the feasibility of mandating thrifts and banks to adhere to "market value accounting" and that depository institution employees pass an examination on the principles and techniques of risk management.

The reporting requirement is revolutionary because it requires the FDIC not only to tell the public how it has been doing, but for the first time also to project how it could fare in the future.

A More Realistic Assessment

To carry out this responsibility, the FDIC must first calculate its baseline exposure – that is, how much it expects to lose if economic conditions do not change – and then report the sensitivity of its exposure estimates under alternative economic assumptions. In both the original House and Senate versions of the thrift legislation, Congress spelled out what conditions it had in mind: variations in interest rates, the "yield curve," and rates of prepayments and defaults on loans.

If the FDIC is to do all of this properly, we believe it must make more realistic assessments of the actual economic values of the institutions under its guard, not simply the values that are reported under current accounting conventions. The distinction is crucial.

Under current generally accepted accounting principles, banks (and recently thrifts) report their "net worth" as the excess of their assets over their liabilities, both measured at their historical cost. But historical cost accounting can seriously mislead the FDIC and the public about the true economic value of the net worth cushion against depository insolvency.

Consider, for example, a thrift with $100 million in assets, measured at historical cost, yielding 9% a year. Suppose these assets are funded by $90 million of deposits, with an average annual cost of 14%. Assume further for the sake of simplicity that the average maturity of both the assets and liabilities is seven years.

Under GAAP accounting, this thrift will show $10 million of net worth, or a capital-to-asset ratio of 10%. But in reality, this thrift is insolvent. The 10% net worth measured under GAAP is clearly insufficient to cover the thrift's 5% "negative interest rate spread" over the seven-year life of its assets and liabilities.

In fact, of course, it was a massive negative interest rate spread in the early 1980s that plunged the entire thrift industry under water. As is now well known, Congress guaranteed this outcome by requiring thrifts to borrow short and lend long. Only by gambling could bankrupt thrifts regain solvency.

Those thrifts that waited patiently for interest rates on their deposits to come down, while prudently using the new powers Congress granted in 1982, are healthy today. Those that tried to gamble their way by bidding up depos-

See COMMENT: Page 13 ▸

Ernst Fleischer is chairman of Franklin Savings Association, Ottawa, Kan., and Robert E. Litan is a senior fellow at the Brookings Institution, Washington.

Funny Money

Edited By TOM LEANDER

Front-Line Action

J.J. Adrien Rameau, attorney-at-law with New York-based Stroock, Stroock & Lavan, glanced at his watch seven times as he moved up the line to the teller windows at the Chemical Bank branch at 35 Water St. in New York last week.

When he finished his transaction, he walked across the bank lobby to customer service officer Grace Yip and announced, "I waited on that line nine minutes." Ms. Yip promptly credited

But at 55 Water in the Wall Street area, Chemical is encountering a more time-sensitive customer.

"We get an average of 20 requests per heavy payroll day," a customer relations officer at the branch said.

— Tom Leander

• • •

Incentive Compensation

Top bankers generally like to have their salaries linked to inflation to guard against erosion of real earnings. In New Zealand, though, the govern-

quarterback Mark Rupien pitching the CDs with the words, "You can't lose."

— Tom Leander

• • •

Passing Glory

At the annual meeting of the International Monetary Fund and the World Bank in Washington last weekend, the governor of a small African country asked his associate: "Whatever happened to statesmanship in American banking?"

▸ Continued from Page 4

it rates for funds and investing the proceeds in risky loans and other wild ventures failed and have now left with taxpayers with the a bill of $100 billion-plus.

Many believe that thrifts are no longer exposed to negative interest spreads now that they can invest in adjustable-rate mortgages. They are wrong. Rates on adjustable-rate mortgages have yearly and lifetime interest rate ceilings coupled with unrestricted prepayment rights, or options favoring the borrower to the detriment of the lender.

Thus, changes in market interest rates on the liabilities that fund these mortgages can still adversely affect a thrift's spread value from adjustable-rate mortgages, unless the thrift offsets the borrower's options. In addition, as interest rates increase, adjustable-rate mortgage defaults become more prevalent.

How then should depository institutions and the FDIC report their loss exposures to the public? They must begin with realistic baseline calculations of net worth based on current economic conditions. Some have suggested that this can only be done by requiring depositories to report both their assets and liabilities at their market values (rather than their historical cost). While this is a worthy long-run objective, in the current marketplace many loans held by depositories are not actively traded and thus do not carry a well-established market price.

But the perfect need not be the enemy of the good. Accountants and regulators can significantly improve the quality of depository institution financial statements by requiring the computation of net worth based on "spread values."

To be specific, the institutions should be required to compute the discounted value of their cash flows – maturing assets and asset earnings net of servicing costs and the important cost of options that are an essential feature of home mortgages – based on discount rates that reflect the institution's cost of funds.

For example, if the institution on average is paying 100 basis points (including all related costs) more than Treasury obligations for deposit instruments, then the discount rate for the cash flow generated from current assets in, say, 10 years hence should be 100 basis points over the prevailing rate on 10-year Treasury securities; similar computations should be made for cash flows built into the institution's balance sheet for other years.

The economic value of the institution's net worth is then measured by the excess of the total discounted values of all its assets minus its liabilities.

Spread-value accounting has many virtues. First, it can easily and readily be done. Second, it prevents institutions from taking undue credit of intangibles such as goodwill. If those intangibles exist, they will be reflected in either high-asset yields or cost savings and thus will be taken into account when computing the discounted values of the institution's assets.

Third, and perhaps most important, spread-value accounting provides the FDIC and the public with more realistic estimates of the numbers that truly matter to the FDIC – the economic net worths of banks and thrifts based on their cost of funds – than GAAP-based net worths that often tell the insurer nothing about the losses to which it is really exposed.

In short, the time has come for responsible members of the depository industry, the accounting profession, academia, and the regulators to work with the Financial Accounting Standards Board to mandate spread-value accounting for depositories. Additionally, depositories should be required to disclose the sensitivity of their net worth to potential changes in economic condition.

Finally, we hope that the Treasury will recommend that directors and high-level executives of banks and thrifts pass risk management examinations.

Training in risk management cannot prevent greed and corruption, which clearly account for some of the mess. But it can help avert the consequences of plain ignorance and stupidity. ■

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Partnership Notices

CERTIFICATE OF LIMITED PARTNERSHIP OF FL INDUSTRIES PARTNERS II The undersigned, being desirous of forming a limited partnership (the "Partnership") pursuant to the laws of the State of New York, and being duly sworn, certify: I. The name of the Partnership is FL INDUSTRIES PARTNERS II. II. The character of the business intended to be transacted by the Partnership is the acquisition of Common Stock of FL Industries Holdings, Inc. and such related investment and financial activities as the General Partner in its sole discretion deems beneficial to the Partnership. III. The location of the principal place of business is at the offices of Forstmann Little & Co., 767 Fifth Avenue, New York, New $179,500; Henry Martin O'Neill, Jr., 3050 Carriage Lane, Hilliard, OH 43026, $200,000; Boston Safe Deposit & Trust Company, as Trustee for Minnesota Mining & Manufacturing Co. Employee Retirement Income Plan, One Boston Place, Boston, MA 02116, $1,637,228; Lewis E. Lehrman, 778 Park Avenue, New York, NY 10021, $478,668; William R. Acquavella, 21 E. 79th Street, New York, New York 10021, $75,000; Continental Bank, National Association, as Trustee of Sears Pension Trust, 30 North LaSalle Street, Chicago, IL 60697, $598,335; Truena American Investments N.V., Pietermaai 25C, Willemstad, Curaca, Netherlands Antilles, $1,000,000; L & M Partnership, 680 E. Romie Lane, Salinas,

Auction Notices

E.F. Fazio auctr lic #798972 sells 10/6/89 9 AM at 372 Ashburton Ave Ynkrs '82 Toyota #JT2MX62E1C0033884 Re: A. Kolonda; 9:30 AM at 3632 Eastchester Road Bx '78 Chevy #1T19M8B539858 Re: M. E. Ayala; 10 AM at 1898 Boston Road Bx '50 Ford #B0EG153887 Re: B. R. Veintimilla; 10:30 AM at 1828 Webster Ave Bx '89 Ford #1FAPP9596KT112752 Re: Fournier Ford, '84 Dodge #2B7FK13G9ER223542 Re: R. Luciano &/or A Rivia, '89 Plymouth #1PKTP48D5KN566099 Re: Elrac, Inc., '83 Mercury #1MEBP6529DT603789 Re: C. V. Diaz, '83 Volvo #YV1DX6946D1012489 Re: K. Weldon, 11:30 AM at 4036 10th Ave NYC '83 Toyota [illegible]

Notices of Foreclosure

INDEX NO. 16455/88 NOTICE OF SALE SUPREME COURT OF THE STATE OF NEW YORK COUNTY OF BRONX BOARD OF MANAGERS, PARKCHESTER NORTH CONDOMINIUM, on behalf of its unit owners, Plaintiff, - against - LAWRENCE W. HOLCOMB, et al, Defendants. Pursuant to a judgment dated August 7, 1989, I will sell at public auction on October 18, 1989, at 9:30 A.M. in the Mezzanine Floor of Room 118 of the Bronx County Courthouse, 851 Grand Concourse, Bronx, New York, the Condominium Unit in the Parkchester North Condominium known as Apartment 7B, in the building known as N-3, and by street address 1596 Unionport Road Bronx, New York and designated as

SUPREME COURT - COUNTY OF BRONX Luis Gonzalez, Plaintiff against Petra Mayorca, et al Defendant(s) Pursuant to a judgment of foreclosure and sale, entered herein and dated March 23, 1989, I, the undersigned Referee, will sell at public auction at the Bronx County Courthouse, 851 Grand Concourse, Bronx, N.Y., in Room 118, Mezzanine, on the 17th day of October, 1989, at 9:30 A.M., premises briefly described. On the east side of Avenue St. John, 11.32 feet south of Prospect Avenue, being a plot 99.71 feet x 20.22 feet x 98.11 feet x 20.29 feet and known as 913 Avenue St. John, Bronx, N.Y. Approximate amount of lien $24,654.40 with interest and costs. Premises will be sold subject to provisions of filed judgment. Index

Table 1

Equity-to-Asset Ratio for the U.S. Banking Industry

1960	8.1
1965	7.5
1970	7.1
1975	6.1
1980	5.8
1985	6.2
1988	6.2
1989 (first half)	6.4

Source: Statistical Abstract of the U.S. (various issues); The FDIC Quarterly Banking Profile, October 1989.

Table 2

Ratio of Risk Adjusted Capital to Risk Adjusted Assets

Commercial Bank Financial Information, Banks with at Least $50 Million
(Assets in Millions of Dollars)

		Ratio <= 0%		0% < Ratio <= 3%		3% < Ratio <= 6%		6% < Ratio		
		Banks	Assets	Banks	Assets	Banks	Assets	Banks	Assets	Universe
March	1989	31	22,142	30	9,342	130	928,703	5351	2,005,497	5555
December	1988	42	22,473	42	11,625	134	925,502	5379	1,901,219	5596
September	1988	31	22,870	50	45,231	122	951,402	5306	1,884,007	5509
June	1988	22	27,107	45	21,872	125	949,019	5356	1,865,583	5548
March	1988	27	35,503	44	31,979	131	941,778	5332	1,813,942	5534
December	1987	19	6,403	38	55,023	149	925,567	5389	1,900,798	5595

Source: Authors' calculations based on data and assistance from Drexel Burnham Lambert MBS Institutional Database

Table 3

Risk-Adjusted Capital Ratios of 16 Weakly Capitalized Banks in September 1988 that were Insolvent by March 1989

Name	9/88	3/89[1]
Alaska Statebank (Anchorage)	0.48	-25.19*
Allied Oklahoma (Oklahoma City)	0.59	-13.51*
Bankers Trust of Lousiana	0.01	-16.87*
Cherry Creek National Bank (Denver)	2.63	-1.38Z
City Nat'l Bank of Plano	0.33	-17.82
Forestwood Nat'l Bank (Dallas)	2.50	-7.38
Industrial Bank (Houston)	1.68	-8.44*
Katy National Bank	1.32	-8.42
Louisiana Bank and Trust (Shreveport)	0.43	-12.34*
MBank Ft. Worth	1.01	-2.01*
MBank Greenville	0.60	-2.79*
NBC Bank San Antonio	0.43	-5.34
Planters Bank and Trust	0.54	-6.01*
Texas American Bk Prestwood (Dallas)	1.54	-2.46
Texas American Bk Temple	0.02	-4.20
Travis Bank and Trust (Austin)	1.64	-11.68*

Source: Authors' calculations based on data and assistance from Drexel Burnham Lambert MBS Institutional Database

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1. Figures marked by an (*) are for December 1988. These insolvent banks were either liquidated or merged by the end of March 1989.

Table 4

Equity Capital-To-Asset Ratios For All Commercial Banks
March 31, 1989[1]

Capital Class	Number	Assets
Less Than 0	90	$20.4 billion
Between 0 and 3%	196	38.7 billion
Between 3% and 6%	1392	1490.3 billion
Over 6%	11325	1601.2 billion
Total	13003	$3150.6 billion

Source: BankSource, W.C. Ferguson & Co. (Irving, Texas)

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[1] Computations based on shareholders equity divided by total (non-risk weighted balance sheet assets).

Table 5

Location of Insolvent and Weakly Capitalized Banks
March 31, 1989
(Based on Generally Accepted Accounting Principles)

	Number	Assets (Billions of Dollars)
Insolvent		
Texas	65	$19.6
Louisiana	7	0.2
Oklahoma	4	0.2
Colorado	3	0.1
Florida	3	0.1
Other	12	0.2
Weak (0-3% Capital-to Assets)		
Texas	88	6.5
Oklahoma	23	0.8
Louisiana	18	1.4
Colorado	13	0.4
Other	54	11.3

Source: Bank Source, W.C. Ferguson & Company (Irving, Texas).

Table 6

Composition of Loan Portfolio, U.S. Commercial Banks (Excluding Interbank Loans)

	1980		1985		1989 (June)	
	Billions of $	(%)	Billions of $	(%)	Billions of $	(%)
Commercial & Industrial	325	(35.6)	496	(33.9)	609	(31.4)
Real Estate	261	(28.6)	425	(29.0)	676	(34.9)
Individual	175	(19.2)	291	(19.8)	361	(18.6)
All Others	152	(16.6)	253	(17.3)	293	(15.1)
Total	913	(100.0)	1465	(100.0)	1939	(100.0)

Note: 1980 and 1985 data are for December. Details may not sum top totals due to rounding.

Sources: Federal Reserve Bulletin, various issues.

Table 7

States Where Real Estate Lending Represents At least 40% of Bank Loan Portfolios

March 31, 1989

	No. of Banks	Real Est. Loan To Total Loans	Commercial Real Est. Loans to Total Loans
Alabama	221	41.4	20.5
Alaska	8	40.3	27.1
Arizona	46	42.8	25.6
Arkansas	256	47.1	23.3
Colorado	446	40.7	22.7
Connecticut	70	51.9	26.0
D.C.	25	44.3	30.8
Florida	415	53.5	30.4
Hawaii	22	46.8	21.2
Louisiana	247	40.9	21.7
Maine	19	51.8	26.9
Mississippi	123	41.3	20.5
Missouri	566	47.8	25.2
New Hampshire	52	42.7	21.9
New Jersey	126	49.5	25.4
New Mexico	93	46.6	25.2
North Carolina	71	43.8	24.0
Oklahoma	458	40.8	22.5
Rhode Island	12	41.8	22.0
South Carolina	80	41.9	26.8
Tennessee	267	41.4	22.1
Virginia	186	41.3	21.4
W. Virginia	197	48.7	15.8
Wisconsin	517	45.8	21.5

Source: BankSource, W.C. Ferguson & Co.

Table 8

LBO Lending of Major Banks (Compared to LDC Lending)

Percent of Equity

Bank	LBO	LDC (Net of Reserve, 12/88)
Bank of Boston	103	20
Bank of New York	127	25
Bankers Trust	89	100
Chase Manhattan	70	140
Citicorp	51	97
Continental Bank	123	69
Man. Hanover	107	200
Security Pacific	63	24
Wells Fargo	119	37

Note: LBO data are for June 30, 1989 (from Wall Street Journal, September 22, 1989, p. C1. LDC debt data are for December 31, 1988 (from First Boston, Bank Handbook, March 1989).

The Brookings Institution

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Economic Studies Program

October 23, 1989

Senator Donald W. Riegle, Jr., Chairman
Senate Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Bldg.
Washington, D.C. 20515

Re: Testimony on Condition of U.S. Banking Industry and the FDIC on October 5, 1989

Dear Senator Riegle:

Since submitting our prepared testimony on the above subject to the Committee on October 5, 1989, officials at the FDIC have brought to our attention certain facts that require an update and revision of our estimate of the condition of the FDIC's reserves. This letter briefly outlines the required revision. It also provides some new information about the condition of the banking industry. If possible, we would like this information to be included in the record of the hearing. The central messages of our testimony remain unchanged: the official FDIC figures, in our view, continue to overstate the condition of the health of the bank insurance fund and a sizebable number of banks with a substantial fraction of the nation's banking assets remain undercapitalized.

In our written testimony, we suggested that the FDIC's reserves were conservatively overstated by approximately $9 billion. In part, this estimate was based on the fact that 90 banks with $20 billion in assets were open and insolvent as of the first quarter of 1989. We applied a 26% loss ratio to those assets, yielding an unrecognized loss for banks in that group of $5.2 billion. We added to that figure another $3.9 billion, representing an expected loss of 10% on the $39 billion in assets held in weakly capitalized banks, or those reporting capital between 0 and 3% of balance sheet bassets. We noted in our testimony that although banks in this category were solvent under generally accepted accounting principles ("GAAP"), many would not be solvent if their assets and liabilities were marked to market. We demonstrated this by showing the significant deterioration in the reported capital positions of many banks that were technically solvent in September 1988 but clearly insolvent 3 to 6 months later.

FDIC officials have since informed us that although there is no explicit mention of this fact in the agency's 1988 Annual Report, the FDIC established loss reserves in 1988 on 18 of the open, insolvent banks in the first quarter of 1989. These banks -- consisting of 17 banks in the Texas American Bank chain and the MCorp Bridge Bank -- held assets of roughly $17 billion. In addition, the agency reports that its average loss ratio in the 1980's was approximately 16% rather than 26%, as we had stated.

We appreciate the FDIC officials bringing these facts to our attention and we have taken them into account in updating our calculations of the FDIC's reserve position. The revised calculations are based on updated data on all banks through the second quarter of 1989, shown in the enclosed Table 1. In brief, the data in that table suggest that as of June 30, 1989 the insurance fund was overstated by at least $5 billion:

--Over 70 insolvent banks with approximately $4 billion in assets were open, suggesting unrecognized losses to the FDIC of nearly $700 million (.16 x 4.2)

--Nearly 200 weakly capitalized banks (other than the MCorp Bridge Bank) were operating with $45 billion in assets, suggesting unrecognized losses to the agency of another $4.5 billion (.10 times 45)

In any event, for reasons we discussed in our testimony, we believe this $5 billion estimate is conservative because it does not include all of the roughly 1,200 banks that the FDIC has placed on its "problem list". Although the FDIC does not report the total assets held by all these banks, we understand that the figure exceeds $100 billion. Given the tendency of GAAP accounting to overstate the condition of weak or problem banks, we believe that it is not unreasonable to project that 5-10 percent of the assets of the problem banks have already realistically been lost. This suggests that the unrecognized losses to the FDIC could be as high as $10 billion.

Because of these considerations we think that the Congress should require public disclosure of the asset size of all undercapitalized and "problem list" banks, as well as relevant operating data. These data should be reported not only for current and future periods, but for the decade as a whole, in order to establish an appropriate historical context.

Finally, the enclosed table continues to document the undercapitalization in the banking industry: over 1,000 banks holding roughly half of all the nation's banking assets have reported capital ratios of between 3 and 6 percent. As we discussed in our testimony, we consider a 6% GAAP capital-to-asset ratio a minimum of good health: during the 1960's average capital ratios for the banking industry ranged even higher -- between 7 and 8 percent -- and this during a decade far more quiescent, in economic terms, than the 1980's (when average capital ratios have ranged between 6 and 6.5 percent). Significantly, Chairman of the

Federal Reserve Board Alan Greenspan recently made a similar point in an address to the American Bankers Association. In addition, the reported capital ratios for many banks in the 3-6 percent category as of June 30, 1989 are overstated because they fail to reflect the substantial additions that certain banks since have made to loan loss reserves for LDC debt and non-performing real estate loans.

Given the current problems in the U.S. banking industry, we strongly support the efforts of FDIC Chairman William Seidman to maintain and enforce strong capital standards for the industry. Only through well-enforced capital standards and intensive supervision can the FDIC protect itself against the unwelcome risks to which we believe the bank insurance fund continues to be exposed.

We hope you and the members of the Committee find this additional information to be of use.

Sincerely,

Robert E. Litan
Robert E. Litan

Dan Brumbaugh/REL
R. Dan Brumbaugh, Jr.

cc: Hon. L. William Seidman

Table 1

Ratio of Total Equity to Total Assets, All U.S. Banks
(Assets in Billions of Dollars)

	Ratio < 0%		0%<Ratio<3%		3%<Ratio<6%		>6% Ratio	
	Banks	Assets	Banks	Assets	Banks	Assets	Banks	Assets
6/89	73	4.2	188	45.7	1158	1611.2	11,964	1747.4
3/89	71	3.3	198	39.6	1220	1645.7	11,957	1664.4
12/88	77	3.5	240	71.1	1380	1722.2	11,793	1541.9
12/87	63	3.5	250	117.0	1567	1638.0	12,172	1423.5
12/86	45	1.3	199	22.0	1969	1769.2	11,888	1138.5

Note: Figures for 12/88 and later exclude MCorp Bridge Bank and Texas American banks in Texas for which the FDIC reports to have established loss reserves in 1988.

Source: Bank Source, W.C. Ferguson & Co., Irving, Texas

The CHAIRMAN. Let me acknowledge the presence of Senator Bond. Did you have any opening comments, Senator Bond?

OPENING COMMENTS BY SENATOR BOND

Senator BOND. Mr. Chairman, because of the tight time schedule, I will just submit my comments for the record. Again, I am pleased that we have an opportunity to hear a diversity of views today, and look forward to learning more from their testimony.

Mr. Chairman, I am pleased that we are beginning these oversight hearings about the health of the banking industry and the FDIC fund. We have just finished 9 months of dishing out billions of dollars of taxpayer funds to recapitalize FSLIC, and I'm sure that I speak for the rest of my colleagues as well when I say that I never want to go through that experience again.

The questions raised about the sufficiency of capital levels and the quality of supervision are very important if we are to limit the Government's exposure through the bank deposit insurance fund. The FSLIC experience has taught us a nasty lesson in this regard and if there is anything useful to come out of the FSLIC debacle, it is this lesson.

I always enjoy hearing from witnesses with sharply differing points of view, so I certainly look forward to the testimony of this panel.

The CHAIRMAN. Mr. McDermott, let me indicate what will be coming here. We have on the Senate floor three votes that will occur back-to-back. One will be 15 minutes in length, and then two are 10 minutes in length. Because we can sort of leave after the first one starts and come back just after the last one starts, our interruption period will not be too great, but there will be an interruption.

I would like to begin your testimony, fully apprising you of the fact that we may need to adjourn before you finish your opening statement.

Mr. McDERMOTT. I will not take any offense.

STATEMENT OF JAMES J. McDERMOTT, JR., EXECUTIVE VICE PRESIDENT, KEEFE, BRUYETTE & WOODS, INC., NEW YORK, NY

Mr. McDERMOTT. Thank you for the opportunity to appear before this Senate committee and share our thoughts on the condition of U.S. commercial banks.

The basic thrust of your inquiry this morning is the safety and soundness of the commercial banking system. Amidst ongoing deregulation and after considerable assaults on the quality of bank assets during the decade of the 1980's, it seems wholly appropriate now to ask, as you are doing: What is the true condition of U.S. commercial banks?

Are we going to revisit any time soon something of the same dimensions as the thrift crisis, or worse? In other words, does the underlying condition of commercial banks represent another thrift crisis in disguise?

In our opinion, the short answer to these questions is that because commercial banks in the aggregate possess impressive financial and operating credentials and enjoy considerably stricter regulatory oversight, they are in a much better position to manage their way through competitive pressures and stresses on their balance sheets than their thrift brethren were. Simply put, the condition of commercial banks is not a thrift crisis in sheep's clothing.

The role of industry consolidation: Importantly, as a backdrop, we are currently in the throes of structural change in commercial banking on a scale more massive than anything since the emergence of new banking entities in the 1930's. As a consequence, power within U.S. banking is shifting away from companies in such traditional centers as New York, Chicago, and San Francisco, and toward those headquartered in new centers such as Charlotte, Columbus, and Pittsburgh.

This notable shift, resulting from the creation of superregional banking companies, is contributing to a reassessment of the banking system's vulnerability. The decline in relative importance of what were once the undisputed largest banks, and the rapid growth of companies that are not only comparably large but also better capitalized, justifies a positive adjustment of the banking system's risk profile.

Nowhere are these changes better illustrated than in the accompanying table of market capitalizations—see exhibit 1 as of September 28, 1989. This reflects simply the current stock price of each bank times its outstanding shares, measuring its total market value.

Less than 7 years ago, the aggregate of the 25 largest such commercial bank market capitalizations amounted to only $29 billion. Today this 25 largest figure has more than tripled to about $100 billion, underscoring the creation and attraction of capital for the banking industry. Furthermore, 44 of the top 50 have capitalizations of $1 billion or more, providing investors with a broad menu of opportunity in bank stocks.

Contrary to an opinion widespread in some quarters, capital is not draining from the banking system, but rather is growing while seeking new entry points, and being redistributed.

However, before we rush to draw glorious conclusions about growth in the overall capital cushion for U.S. commercial banks, some perspective is in order. When compared with those of companies in certain U.S. industries, or of some foreign banking companies, aggregate market capitalization for U.S. banks is relatively small.

For example, IBM alone has a market capitalization of $70 billion, approximately the current aggregate for the 25 largest U.S. banks. The 13 largest Japanese banks possess market capitalizations totalling $500 billion, or roughly quintuple the level of those 25 U.S. banks.

The message here is straightforward: If U.S. banking is to be competitive globally, and if the banking system is to nurture capital formation as a buffer against crisis, then the consolidation process should be encouraged and even accelerated.

Imagine for a moment the potential benefits of cross-regional combinations in offsetting the sometimes severe cyclical vagaries of individual regional economies. For example, if strong banks in California, Florida, and Pennsylvania had been wedded to those in Texas, how potentially less damaging to the banking system would have been the fall-out from the energy industry. In this regard, it would be useful for Congress to establish incentives for states to allow further liberalization, where applicable, of their interstate banking laws, and also incentives to emphasize high levels of common equity and asset quality in developing the rules for participation in interstate banking.

With industry consolidation as the keynote, let us now briefly review the level and quality of bank profits, the status of asset quality, and the degree of capital adequacy, using the Keefe Composite Bank, KCB, a representative sample of 24 money center and large regional banks, as a proxy for industry experience. See exhibit 2 on the Keefe Composite Bank, a history of banking performance.

The level and quality of bank profitability: There is ample evidence that over time bank profitability not only exhibits relative stability, but rivals that of the industrial sector. For the period 1980 to 1986, average return on assets hovered between 0.66 percent and 0.70 percent, while average return on common equity ranged between 13 percent and 14.5 percent.

Over the last 2½ years, the creation of material extra loss reserves against exposure to lesser-developed-country, or LDC, debt has interrupted the basic trend line of earnings and profitability. The reserving decisions of 1987 plunged the KCB or Keefe Composite Bank into the red, while the ensuing year witnessed especially strong performance because of tax benefits related to the previous year's LDC provisions and nonrecurring revenues, mostly gains on sale of assets.

The historical record also provides another glimpse of the stability and superior performance of the banking industry, versus the industrial sector. Earnings for 22 consecutive 5-year periods, starting with 1964 and running through estimates for 1990, reveal that compound growth for the KCB composite exceeded that of the S&P-500 companies in 15 of those 22 periods. Furthermore, the standard deviation of bank earnings for this stretch was less than half that of the industrials, highlighting the lesser volatility of bank results.

The industry's current earnings outlook includes diverse and cautionary trends. Recent decisions by certain money center banks to launch another round of high extra LDC loss provisions will likely cause other banking companies to reassess the adequacy of their own reserves, against both LDC and non-LDC credit problems.

As a result, there is a high probability that the generally favorable earnings performance of money centers in the first half of 1989 will not persist in the second. This scenario is not unlike the one that developed after the LDC reserving decisions made in mid-1987. Then, as likely now, banks engaged in heavy LDC reserving took the occasion of resulting battered earnings to cleanse their portfolios of other troubled credits. We called this the "kitchen sink syndrome." Thus, the saw-toothed pattern of earnings sharply down in 1987 and then strongly up in 1988 could very well be repeated during this year and next.

It can be debated whether such heavy providing for loss results in stronger banks and a strengthened banking system. We think it does. Suffice it to point out that these actions represent a cleaning out of old problems without comparable new ones on the horizon. Stock market reaction has been quite favorable, and the ability of the affected companies to raise equity capital has not been impaired. By thus endorsing the money center banks 'approach, hard-nosed investors have rendered their own verdict on the result.

At the same time, because of their volatility, the quality of recent earnings has generally been spotty at money center banks. Our analysis remains focused on the level of the banks 'core earnings, as adjusted to exclude the effect of nonrecurring income and expense, LDC-related tax benefits, extremely volatile revenues and, of course, the special loss provisions themselves.

These adjustments reveal a much steadier rate of earnings advance at major banks. Most recently, the growth of the resulting core earnings also reflects the slower economic environment in which banks are operating.

The quality of bank assets: There is little question that the decade of the 1980s witnessed marked deterioration in the quality of assets at the largest banks. Lending excesses exposed by the shift from high to low inflation caused severe dislocation for some segments of the financial services sector.

Again based on the experience of the index, the incidence of net charge-offs against average loans more than tripled between 1981 and 1988, from 0.30 percent to 0.95 percent; the level of nonperforming loans nearly tripled as well, from 1.3 percent of total loans in 1980 to 3.7 percent in 1987.

Beginning in 1987, we necessarily started to differentiate between the LDC and the non-LDC aspects of asset quality. It is important to note that the continuing atypically high level of write-offs and nonperforming loans at the largest banks is due entirely to LDC exposures. Until recently, on the other hand, non-LDC asset quality has shown moderate improvement. A key corollary is that asset quality at most superregional and larger regional banks has held relatively steady throughout the 1980's, since LDC lending at most such banks was less significant or even non-existent. By now, in fact, it has been largely eliminated throughout much of the large regional category.

The recent moderate reversal in the trend of non-LDC asset quality can be traced mainly to problems in real estate lending and small but growing amounts of troubled leveraged buy-out credits. Thus, the current outlook for asset quality at commercial banks depends crucially on trends in three main areas of exposure: Lesser-developed country debt, mainly for the money centers; leveraged buy-outs, and real estate.

LDC debt has been a major problem at the largest U.S. commercial banks for 7 years now. We do not believe, however, that the light we see at the end of this long tunnel is an oncoming freight train. The reason: LDC exposures have been coming down, while reserve levels continue to be beefed up. Furthermore, whereas we used to refer to the amounts of such banks' LDC exposure as a multiple of their equity, it is down now in most cases to a fraction of equity, and declining. Between June 30, 1987 and June 30, 1989, LDC exposure at a group of selected money center and large regional banks declined by 23 percent on average, from $72 billion to $55 billion. See accompanying exhibit 3.

Indicative of the pace of reduction has been Citicorp's experience in reducing their exposure by roughly $3 billion during that 2-year period. Today Citicorp can match its longer-term LDC exposure against a similar amount of common equity. To borrow a phrase from the airline, in the extremely unlikely event that all of Citicorp's longer-term LDC loans proved uncollectible, the company's equity could absorb the entire loss.

More importantly, all U.S. banks have the capacity, with varying degrees of financial pain, to reserve aggressively against their LDC exposures, effectively removing that burden from the foreground of investor attention. While clearly not fully resolved for the largest U.S. banks, the LDC factor is being significantly reduced as a threat to their balance sheets.

Evidence of the beneficial effect of these developments is now clearly available in the marketplace. Since December 1987, share prices at the money center banks most heavily exposed to LDC's have risen on average by 93 percent. Furthermore, the unfavorable gap in earnings multiples between money center bank stocks and those of regionals, at its widest in 1987, has narrowed considerably. LDC debt had been an overwhelming negative influence on the share prices of money center banks, and that cloud has been lifting.

Of importance, going forward, is the question of which U.S. commercial banks are going to lend further to LDC countries, and under what circumstances. It is illogical to think that, having just aggressively reserved against possible LDC loan losses, the largest banks are likely to extend nonguaranteed amounts of term credit in the future.

Domestically, asset quality is challenged by leveraged buy-out and real estate loans. The proliferation of leveraged buy-out loans in the latter stages of an economic expansion should trigger concern. Aggregate LBO exposures, including related equity investments, exceed equity for most money center banks.

The rate of their growth, the possibility of recourse to banks that have sold off such loans, and the recent degree of dependence on such lending for revenue, reinforce the need for a watchful eye on LBO exposure. The nature and style of a given bank's LBO activity affect the extent of associated risk, but vulnerability in this area will likely remain tied mainly to the condition of the economy, the level of interest rates, and other so-called exogenous economic factors. In any case, monitoring of LBO's is key to anticipating the overall trend of potential problem credits.

In this regard, I would like to stress that it is extremely important that a common definition be better developed in terms of banks presenting this information. At the moment, very little information is given out in terms of the equity investments that these banks have. There are hundreds of millions of dollars of investments in blind LBO funds in which banks participate, and there is very little disclosure of that information at this point in time.

Real estate problems are worsening at commercial banks this year. The weakest regional markets are in the Northeast and Southwest, and individual States such as Arizona, New Hampshire, and Tennessee are especially susceptible.

We do not think that real estate represents a pervasive, permanent risk to the commercial banking system, but it will continue lowering asset quality this year and next. A key uncertainty in this regard will be the impact on real estate markets of the prospective disposition of billions of dollars of assets by the Resolution Trust Corporation.

Capital adequacy: For much of this decade, an impression of capital adequacy prevailed among banking companies because of a regulatory emphasis on primary capital ratios, which included not only the reserve for loan losses but also debt slated to become equity.

In essence, this allowed the goal posts to be moved, if necessary, to accommodate the illusion of capital adequacy. From 1980 through 1988, the ratio of primary capital to assets for the KCB banks increased by over 50 percent, while common equity grew only a little faster than assets.

The regulatory introduction of risk-based capital ratios is having a salutary effect by emphasizing growth in commercial banks' common equity, relative to intangible assets and the degree of risk in all the assets being supported.

It balances the lack of growth in common equity. The regulatory introduction of risk-based capital ratios is having a salutary effect by emphasizing growth in commercial banks' common equity relative to the size of intangible assets and the degree of risk in all of the assets being supported.

Furthermore, securitization of assets is contributing to improving the capital adequacy profile of large banks. In effect, banks are selling and distributing loans to a much greater extent today, rather than holding them to maturity in their own portfolios.

Conclusion: Our assignment this morning has been to assess the condition of U.S. commercial banks, and the factors contributing to it. We have looked briefly at the beneficial possibilities of industry consolidation, and provided an overview of trends in profitability, asset quality, and capital adequacy.

We trust that this overview has supported our belief that the condition of commercial banks today in no way contains the seeds of the kind of crisis that has overtaken the thrift industry. Furthermore, the problems of money center banks should not be allowed to obscure the relative health of their regional and superregional counterparts, which are becoming more and more significant in the overall banking picture.

To be sure, there are sizeable problems and risks confronting all commercial banks. At times, conditions in specific regional markets can turn quite averse, putting considerable pressure on banks operating within them.

As we see it, however, commercial banks have shown great resilience and the ability to adapt to a variety of adversity, ever since the Great Depression. Nothing has changed in that respect. Given a continuing intelligent attitude on the part of regulators, the banks' human and physical resources will support their future health and survival.

[The complete prepared statement of James J. McDermott, Jr. follows:]

KEEFE, BRUYETTE & WOODS, INC.

JAMES J. McDERMOTT, Jr.

Keefe, Bruyette & Woods, Inc.
New York City

October 5, 1985

before the

Senate Committee on Banking
Housing and Urban Affairs
Washington, D. C.

SUMMARY

Good morning! Thank-you for the opportunity to appear before this Senate committee and share with you our views on the condition of U.S. commercial banks. Keefe, Bruyette & Woods, Inc., or KBW as it is commonly known, is a broker/dealer and investment-banking firm significantly involved with analysis of commercial-bank and thrift securities.

The basic thrust of your inquiry this morning is the safety and soundness of the U.S. commercial banking system. Amidst ongoing deregulation, and after considerable assaults on the quality of bank assets during the decade of the 1980's, it seems wholly appropriate now to ask -- as you are doing -- what is the true condition of U.S. commercial banks? Are we going to revisit, anytime soon, something of the same dimensions as the thrift crisis -- or worse? In other words, does the underlying condition of commercial banks represent another thrift crisis in disguise?

In our opinion, the short answer to these questions is that because commercial banks in the aggregate possess impressive financial and operating credentials, and enjoy considerably stricter regulatory oversight, they are in a much better position to manage their way through competitive pressures and stresses on their balance sheets than their thrift brethren were. Simply put, the condition of commercial banks is not a thrift crisis in sheep's clothing!

I. ROLE OF INDUSTRY CONSOLIDATION

Importantly, as a back drop, we are currently in the throes of structural change in commercial banking on a scale more massive than anything since the emergence of new banking entities in the 1930's. As a consequence, power within U.S. banking is shifting away from companies in such traditional centers as New York, Chicago, and San Francisco, and toward those headquartered in new centers such as Charlotte, Columbus, and Pittsburgh. This notable shift, resulting from the creation of super-regional banking companies, is

Exhibit I

FIFTY LARGEST BANKS RANKED BY MARKET CAPITALIZATION
as of September 28, 1989

Market-Cap Rank at Year-End: 1982	1984	1985	1986	1987	1988	9/28/89		9/28/89 Market Cap * (in $mm)	% Change since 12/31/88	CGR ** since 12/31/82	Rank of Extrapolated Market Cap. at 9/28/94
1	1	1	2	2	1	1	Citicorp	10,943	33%	16%	5
3	2	2	1	1	2	2	J.P. Morgan	8,059	27%	18%	7
2	3	5	10	29	6	3	BankAmerica	7,133	118%	14%	13
9	4	6	6	5	3	4	Security Pacific	5,353	32%	28%	9
39	33	24	22	22	26	5	Avantor Financial	4,592 c	201%	48%	1
27	13	15	15	21	14	6	NCNB Corp.	4,560	94%	43%	2
28	14	14	12	3	4	7	PNC Financial	4,451	29%	43%	3
20	17	16	19	4	7	8	Banc One	4,420	54%	33%	6
21	15	20	5	8	5	9	Wells Fargo	4,389	38%	33%	8
11	6	4	3	6	8	10	Bankers Trust	4,374	54%	25%	14
4	7	3	4	13	11	11	Chase Manhattan	3,877	54%	14%	26
29	23	11	8	7	10	12	SunTrust Banks	3,304	29%	38%	11
34	37	25	31	34	13	13	Bank of New York	3,303	41%	39%	10
a	48	46	28	9	9	14	Fleet/Norstar	3,122	14%	49%	4
24	18	12	13	14	15	15	First Wachovia	3,039	39%	30%	18
16	16	17	20	31	21	16	First Chicago	2,997	62%	23%	24
6	5	7	9	12	19	17	First Interstate	2,981	50%	14%	30
47	26	13	7	10	12	18	First Union	2,629	11%	41%	12
10	8	8	11	28	20	19	Chemical Banking	2,571	29%	15%	31
a	40	40	27	27	18	20	National City	2,407	21%	40%	15
32	22	18	17	15	16	21	Barnett Banks	2,377	17%	32%	20
30	35	26	30	18	22	22	NBD Bancorp.	2,348	32%	31%	22
5	9	10	14	32	31	23	Manufacturers Hanover	2,217	53%	7%	42
18	31	29	32	30	30	24	Norwest	2,138	50%	19%	32
a	a	47	33	19	23	25	Shawmut National	1,910	8%	46%	16
40	29	28	26	24	24	26	CoreStates Financial	1,853	16%	31%	27
22	24	21	16	20	25	27	Bank of Boston	1,838	12%	18%	36
a	42	37	34	17	28	28	First Fidelity	1,804	16%	42%	19
a	a	50	47	33	34	29	MNC Financial	1,740	32%	40%	21
a	47	33	40	26	29	30	Midlantic	1,738	20%	47%	17
14	11	19	21	37	47	31	Mellon Bank	1,546	69%	11%	43
38	43	a	48	35	38	32	U.S. Bancorp	1,497	58%	26%	35
26	28	32	18	23	32	33	Republic New York	1,459	13%	21%	38
a	a	23	23	16	27	34	Bank of New England	1,428	-6%	41%	25
a	a	45	39	40	39	35	State Street Boston	1,354	42%	30%	33
13	12	9	29	44	35	36	Continental Bank	1,351 b	21%	8%	46
a	a	a	a	a	36	37	Boatmen's Bancshares	1,296	24%	46%	23
a	a	a	a	43	37	38	Fifth Third Bancorp.	1,295	31%	NA	NA
23	21	22	24	25	33	39	First Bank System	1,267	-2%	14%	44
a	a	49	a	41	41	40	KeyCorp	1,181	43%	41%	29
a	a	a	44	38	40	41	UJB Financial	1,166	29%	43%	28
a	a	a	a	53	53	42	Northern Trust	1,043	55%	26%	41
a	a	44	41	48	42	43	Signet Banking	1,032	31%	38%	34
36	39	48	42	42	43	44	Ameritrust	1,011	31%	18%	45
a	a	a	a	a	51	45	Crestar Financial	993	46%	NA	NA
a	a	a	a	a	44	46	Union Bank	969	25%	NA	NA
a	a	a	a	a	57	47	Huntington Bancshares	947	46%	33%	37
a	a	a	a	a	63	48	Bancorp Hawaii	908	62%	NA	NA
a	a	a	a	50	58	49	Dominion Bankshares	873	40%	31%	40
a	a	a	a	a	a	50	Manufacturers National	873	30%	33%	39

* Market capitalization = total common shares outstanding (as of 12/31/88) multiplied by market price per share at 9/28/89.
a: Not ranked among the top 50 market capitalizations at date indicated.
b: Continental's shares include the preference shares owned by the FDIC.
c: Market cap. is pro forma for the pending merger of Citizens & Southern and Sovran.
** Compound growth rate.
NA: Not available.

AGGREGATE OF 25 LARGEST MARKET CAPITALIZATIONS AT INDICATED DATES	
SEPTEMBER 28, 1989	$99.5 billion
DECEMBER 31, 1988	$69.7
DECEMBER 31, 1987	$56.4
SEPTEMBER 30, 1987	$74.9
DECEMBER 31, 1986	$60.3
DECEMBER 31, 1982	$29.2

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contributing to a reassessment of the banking system's vulnerability. The decline in relative importance of what were once the undisputedly largest banks, and the rapid growth of companies that are not only comparably large but also better capitalized, justifies a positive adjustment of the banking system's risk profile.

Nowhere are these changes better illustrated than in the accompanying table of market capitalizations (see Exhibit I as of September 28, 1989). This reflects simply the current stock price of each bank times its outstanding shares, measuring its total market value. Less than seven years ago, the aggregate of the twenty-five largest such commercial-bank market capitalizations amounted to only $29 billion; today this twenty-five largest figure has more than tripled to about $100 billion, underscoring the creation and attraction of capital for the banking industry. Furthermore, forty-four of the top fifty have capitalizations of $1 billion or more, providing investors with a broad menu of opportunity in bank stocks. Contrary to an opinion widespread in some quarters, capital is not draining from the banking system, but rather is growing while seeking new entry points, and being redistributed.

However, before we rush to draw glorious conclusions about growth in the overall capital cushion for U.S. commercial banks, some perspective is in order. When compared with those of companies in certain U.S. industries, or of some foreign banking companies, aggregate market capitalization for U.S. banks is relatively small. For example, IBM alone has a market capitalization of $70 billion, approximating the current aggregate for the twenty-five largest U.S. banks; and the 13 largest Japanese banks possess market capitalizations totaling $500 billion, or roughly quintuple the level of those twenty-five U.S. banks.

The message here is straightforward: if U.S. banking is to be competitive globally, and if the banking system is to nurture capital formation as a buffer against crisis, then the consolidation process should be encouraged and even accelerated. Imagine for a moment the potential benefits of cross-regional combinations in offsetting the sometimes-severe cyclical vagaries of individual regional economies. For example, if strong banks in California, Florida, and Pennsylvania had been wedded to those in Texas, how potentially less damaging to the banking system would have been the fallout from the energy industry. In this regard, it would be useful for Congress to establish incentives for states to allow further liberalization, where applicable, of their interstate-banking laws, and also incentives to emphasize high levels of common equity and asset quality in developing the rules for participation in interstate banking.

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Exhibit II

THE KBW COMPOSITE BANK
A History of Banking Performance
(1980 to 1989)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989**
PROFITABILITY										
Return on Average Assets (%)										
Net Income	0.70	0.66	0.68	0.67	0.67	0.66	0.69	-0.07	0.99	1.05
IBST	0.73	0.70	0.71	0.68	0.68	0.60	0.65	-0.08	1.00	1.05
Return on Average Earning Assets (%)										
Net Income	0.87	0.80	0.81	0.79	0.78	0.74	0.79	-0.08	1.11	1.18
IBST	0.91	0.85	0.83	0.79	0.79	0.70	0.73	-0.09	1.12	1.18
Return on Average Common Equity (%)										
Net Income	14.50	13.97	13.21	13.35	13.04	14.16	14.18	-1.17	18.42	17.53
IBST	15.33	14.93	14.31	13.33	13.05	12.81	12.50	-1.30	17.93	17.39
Net Interest Margin (FTE) (%)	3.95	3.86	4.03	4.00	4.01	3.99	4.11	3.83	4.23	4.46
ASSET QUALITY & PROTECTION										
Net Charge-Offs/Avg.Loans (%)	0.36	0.30	0.45	0.41	0.46	0.54	0.80	0.88	0.95	0.80
NCOs/ALs, ex LDC NCOs	NA	NA	NA	NA	NA	NA	NA	0.67	0.55	0.54
Loan-Loss Reserve/ Year-end Loans (%)	1.06	1.07	1.13	1.21	1.29	1.50	1.65	2.91	2.24	2.21
LLR/TLs, ex LDC Reserves	NA	NA	NA	NA	NA	NA	NA	1.38	1.42	1.43
Non-Performing Assets/ Year-End Loans + OREO (%)	1.32	1.82	2.60	2.54	2.92	2.75	2.78	3.71	3.03	3.11
NPAs/TLs & OREO, ex LDC *	NA	NA	NA	NA	NA	NA	NA	2.26	1.59	1.88
Pre-tax Income & PLL/NCOs (x)	6.38	5.64	4.67	5.37	4.70	4.39	3.24	2.84	3.05	3.96
Provision/Net Charge-Offs (X)	1.23	1.42	1.25	1.28	1.61	1.46	1.40	2.29	0.83	0.97
Loan-Loss Reserve/NPLs (%)	98.96	59.62	44.41	49.18	48.31	57.79	68.35	109.04	109.56	91.82
Non-LDC LLR/Non-LDC NPLs *	NA	NA	NA	NA	NA	NA	NA	73.98	95.91	88.47
CAPITAL STRENGTH										
Internal Capital Generation Rate (%)										
Net Income	9.30	8.69	8.10	7.94	8.15	8.90	10.20	-6.17	12.67	11.72
IBST	10.30	9.85	9.40	8.93	8.22	7.87	8.67	-6.41	12.36	11.67
Average Common Equity/Assets (%)	4.84	4.99	4.83	4.98	4.92	4.99	5.10	4.86	5.27	5.56
Average Total Equity/Assets (%)	4.88	5.07	4.98	5.35	5.40	5.53	5.61	5.37	5.65	5.85
Average Total Equity/Loans (%)	9.03	9.16	8.64	8.92	8.52	8.34	8.68	7.98	8.14	8.67
EOP Primary Capital/Assets (%)	5.42	5.45	5.56	5.96	6.45	6.85	7.11	8.01	8.18	8.02

* Non-LDC non-performing assets exclude only those related to Argentina, Brazil, and Ecuador.

** First-half 1989 annualized.

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II. THE LEVEL AND QUALITY OF BANK PROFITABILITY

There is ample evidence that over time bank profitability not only exhibits relative stability, but rivals that of the industrial sector. For the period 1980-86 average return on assets hovered between .66% and .70%, while average return on common equity ranged between 13% and 14.5%. Over the last two and one-half years, the creation of material extra loss reserves against exposure to lesser-developed-country (LDC) debt has interrupted the basic trendline of earnings and profitability. The reserving decisions of 1987 plunged the KCB or Keefe Composite Bank into the red, while the ensuing year witnessed especially strong performance, because of tax benefits related to the previous year's LDC provisions and non-recurring revenues -- mostly gains on sale of assets.

The historical record also provides another glimpse of the stability and superior performance of the banking industry versus the industrial sector. Earnings for twenty-two consecutive 5-year periods, starting with 1964 and running through estimates for 1990, reveal that compound growth for the KCB composite exceeded that of the S&P-500 companies in fifteen of those twenty-two periods. Furthermore, the standard deviation of bank earnings for this stretch was less than half that of the industrials, highlighting the lesser volatility of bank results.

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It can be debated whether such heavy providing for loss results in stronger banks and a strengthened banking system. We think it does. Suffice it to point out that these actions represent a cleaning out of old problems without comparable new ones on the horizon; stock-market reaction has been quite favorable, and the ability of the affected companies to raise equity capital has not been impaired. By thus endorsing the money-center banks' approach, hard-nosed investors have rendered their own verdict on the result.

At the same time, because of their volatility the quality of recent earnings has generally been spotty at money-center banks. Our analysis remains focused on the level of the banks' core earnings, as adjusted to exclude the effect of non-recurring income and expense, LDC-related tax berefits, extremely volatile revenues, and -- of course -- the special loss provisions themselves. These adjustments reveal a much steadier rate of earnings advance at major

Exhibit III

REDUCTIONS IN LDC EXPOSURE AMONG SELECTED REGIONAL AND MONEY-CENTER BANKING COMPANIES

	JUNE 1989	JUNE 1987	REDUCTIONS	
			DOLLAR AMOUNT	PERCENT
CITICORP	$11.6 B	$14.6B	$3.0 B	21%
MANUFACT. HANOVER	7.9	9.2	1.3	14%
CHASE MANHATTAN	7.3	8.7	1.4	16%
CHEMICAL BANKING	5.6	5.9	0.3	6%
J.P. MORGAN	4.0 (a)	5.4	1.4	26%
BANKERS TRUST	3.9	4.0	0.1	3%
BANKAMERICA	8.4	10.4	2.0	19%
FIRST CHICAGO	1.9	3.1	1.3	40%
CONTINENTAL BANK	1.7	2.4	0.7	29%
SECURITY PACIFIC	0.8 (b)	2.2	1.4	65%
FIRST INTERSTATE	0.8 (b)	1.6	0.8	47%
WELLS FARGO	0.2 (c)	1.9	1.8	92%
BANK OF BOSTON	0.8 (b)	1.4	0.6	40%
MNC FINANCIAL	0.1	0.2	0.1	55%
FLEET/NORSTAR	0.0 (b)	0.1	0.1	66%
NORWEST	0.0 (b)	0.5	0.5	98%
	55.0	71.8	16.8	23%

(a) Estimated exposure is as of September 30, 1989.
(b) As of March 31, 1989.
(c) Includes short-term outstandings only. WFC no longer has any term LDC exposure.

NOTE: Exposures only in dollars (and not in local currency) are included. Amounts shown are in billions.

banks; most recently, the growth of the resulting core earnings also reflects the slower economic environment in which banks are operating.

III. THE QUALITY OF BANK ASSETS

There is little question that the decade of the 1980's witnessed marked deterioration in the quality of assets at the largest banks. Lending excesses exposed by the shift from high to low inflation caused severe dislocation for some segments of the financial-services sector. Again based on the experience of the KCB, the incidence of net charge-offs against average loans more than tripled between 1981 and 1988, from .30% to .95%; the level of non-performing loans nearly tripled as well, from 1.3% of total loans in 1980 to 3.7% in 1987.

Beginning in 1987, we necessarily started to differentiate between the LDC and the non-LDC aspects of asset quality. It is important to note that the continuing atypically high level of write-offs and non-performing loans at the largest banks is due entirely to LDC exposures. Until recently, on the other hand, non-LDC asset quality has shown moderate improvement. A key corollary is that asset quality at most super-regional and larger regional banks has held relatively steady throughout the 1980's, since LDC lending at most such banks was less significant or even nonexistent; by now, in fact, it has been largely eliminated throughout much of the large-regional category.

The recent moderate reversal in the trend of non-LDC asset quality can be traced mainly to problems in real estate lending and small but growing amounts of troubled leveraged-buy-out credits. Thus the current outlook for asset quality at commercial banks depends crucially on trends in three main areas of exposure: lesser-developed-country debt (mainly for the money-centers), leveraged buyouts, and real estate.

LDC debt has been a major problem at the largest U.S. commercial banks for seven years now; we do not believe, however, that the light we see at the end of this long tunnel is an oncoming freight train. The reason: LDC exposures have been coming down, while reserve levels continue to be beefed up. Furthermore, whereas we used to refer to the amounts of such banks' LDC exposure as a multiple of their equity, it is down now in most cases to a fraction of equity, and declining. Between 6/30/87 and 6/30/89, LDC exposure at a group of selected money-center and large regional banks declined by 23% on average, from $72 billion to $55 billion (see accompanying Exhibit III).

Indicative of the pace of reduction has been Citicorp's experience in reducing their exposure by roughly $3 billion during that two-year period. Today, Citicorp can match its longer-term LDC exposure against a similar amount of common equity. To borrow a phrase from the airline, in the extremely unlikely event that all of Citicorp's term LDC loans proved uncollectible, the company's equity could absorb the entire loss.

More importantly, all U.S. banks have the capacity, with varying degrees of financial pain, to reserve aggressively against their LDC exposures, effectively removing that burden from the foreground of investor attention. While clearly not fully resolved for the largest U.S. banks, the LDC factor is being significantly reduced as a threat to their balance sheets.

Evidence of the beneficial effect of these developments is now clearly available in the marketplace. Since December 1987, share prices at the money-center banks most-heavily exposed to LDC's have risen on average by 93%. Furthermore, the unfavorable gap in earnings multiples between money-center bank stocks and those of regionals -- at its widest in 1987 -- has narrowed considerably. LDC debt had been an overwhelming negative influence on the share prices of money-center banks, and that cloud has been lifting.

Of importance, going forward, is the question of which U.S. commercial banks are going to lend further to LDC countries, and under what circumstances. It is illogical to think that, having just aggressively reserved against possible LDC loan losses, the largest banks are likely to extend non-guaranteed amounts of term credit in the future.

Domestically, asset quality is challenged by leveraged-buyout and real-estate loans. The proliferation of leveraged-buyout loans in the latter stages of an economic expansion should trigger concern. Aggregate LBO exposures, including related equity investments, exceed equity for most money-center banks. The rate of their growth, the possibility of recourse to banks that have sold off such loans, and the recent degree of dependence on such lending for revenue reinforce the need for a watchful eye on LBO exposure. The nature and style of a given bank's LBO activity affect the extent of associated risk, but vulnerability in this area will likely remain tied mainly to the condition of the economy, the level of interest rates, and other so-called exogenous economic factors. In any case, monitoring of LBOs is key to anticipating the overall trend of potential problem credits.

Real estate problems are worsening at commercial banks this year. The weakest regional markets are in the Northeast and Southwest, and individual states such as Arizona, New Hampshire, and Tennessee are especially susceptible. We do not think real estate represents a pervasive, permanant risk to the commercial-banking system, but it will continue lowering asset quality this year and next. A key uncertainty in this regard will be the impact on real-estate markets of the prospective disposition of billions of assets by the Resolution Trust Corporation.

IV. CAPITAL ADEQUACY

For much of this decade, an impression of capital adequacy prevailed among banking companies because of a regulatory emphasis on primary-capital ratios, which included not only the reserve for loan losses but also debt slated to become equity. In essence, this allowed the goal posts to be moved, if necessary, to accommodate the illusion of capital adequacy. From 1980 through 1988, the ratio of primary capital to assets for the KCB banks increased by over 50%, while common equity grew only a little faster than assets. The regulatory introduction of risk-based capital ratios is having a salutary effect by emphasizing growth in commercial banks' common equity, relative to the six of intangible assets and the degree of risk in all the assets being supported. Furthermore, securitization of assets is contributing to improving the capital-adequacy profile of large banks. In effect, banks are selling and distributing loans to a much greater extent today, rather than holding them to maturity in their own portfolios.

V. CONCLUSION

Our assignment this morning has been to assess the condition of U.S. commercial banks, and the factors contributing to it. We have looked briefly at the beneficial possibilities of industry consolidation, and provided an overview of trends in profitability, asset quality, and capital adequacy. We trust that this overview has supported our belief that the condition of commercial banks today in no way contains the seeds of the kind of crisis that has overtaken the thrift industry. Furthermore, the problems of money-center banks should not be allowed to obscure the relative health of their regional and super-regional counterparts, which are becoming more and more significant in the overall banking picture.

To be sure, there are sizable problems and risks confronting all commercial banks. At times conditions in specific regional markets can turn quite adverse, putting considerable pressure on banks operating within them. As we see it, however, commercial banks have shown great resilience, and the ability to adapt to a variety of adversity, ever since the Great Depression. Nothing has changed in that respect; and given a continuing intelligent attitude on the part of regulators, the banks' human and physical resources will support their future healthy and survival.

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The **Chairman**. Thank you very much.

We are going to recess the committee for about 25 or 30 minutes while we go and vote. I want to acknowledge the presence in the back of the room of a number of international guests, bankers from Germany who are here. We are pleased to have you with us.

The committee stands in recess for about 25 or 30 minutes.

[Recess.]

The **Chairman**. Let me call the committee back to order.

I feel just a word of explanation is in order, and that is that, as you may know, we are in the midst of that time in the legislative season where we are going day and night. The Finance Committee, of which I am a member, was in the other night on the reconciliation issue until 3:00 a.m., and as a result the floor schedule and the committee schedules are all intertwined, and we just had an extra vote added to the three that were planned this morning, to try to batch them so that the interruptions would be a little more manageable than they sometimes are when they just come at random moments.

And so in any event, I am always sensitive to interruptions in a hearing like this, which we have planned for some time, and of course at a time not able to foresee that we would be in this situation this morning.

The issue that we decided out there has to do with flag burning, and if any of you are in any way thinking of doing so you will now spend a year in jail. [Laughter.]

So for what it is worth, that is what we have been working on over there with these votes.

We are now ready to hear your testimony, and you have come from Texas to share with us and we are interested in hearing that now.

STATEMENT OF ALEX SHESHUNOFF, PRESIDENT, SHESHUNOFF INFORMATION SERVICES, INC., AUSTIN, TX

Mr. **Sheshunoff**. Thank you, Mr. Chairman.

Most of my testimony focuses on real estate lending, and there are some additional remarks attached.

Basically, what we have found is that rapid loan growth is the best leading indicator of future bank problems. Not only does rapid loan growth tell you where in the loan portfolio the problems are going to be, but also the magnitude of them.

The other thing we have discovered is that rapid loan growth very often finances speculative excesses, and as the speculative excesses occur you build up the potential for having a financial crisis because the higher values go, the harder they are going to fall, and what we have seen is that when loan demand in a specific area dramatically increases there is a tendency for the values to get totally out of hand. When they do, they often come down hard, and there is trouble in the loan portfolio.

Now, one of the things we have seen is that in some regions of the country you have a very clear potential for speculative excesses developing, particularly in the Northeast, with regard to real estate. We saw it happen in Texas. We saw it happen in Arizona. There are the same earmarks in the Northeast, not to the same degree that we saw in the Southwest, but some of the same elements are clearly there.

The challenge for the regulators is to slow it down sooner rather than later. The nation has already had a taste of what a burst of the speculative real estate bubble can mean.

Now, looking at the state of banking today, first of all, I want to look very briefly at consumer lending. I think some of the major financial institutions now have a slogan of "Yesterday the world, tomorrow America." In short they have discovered that the American consumer basically repays his debts faster than lesser developed countries.

In fact, as we look at Texas, we see that 1.3 percent of the consumer loans are nonperforming versus 4.8 percent of the commercial loans and 9.6 percent of the real estate loans.

Basically, the American consumer has a high level of personal integrity and even in hard times pays his debts—Texas certainly has to qualify for being into hard times right now.

Looking at commercial lending, commercial loans have been growing very modestly. In terms of the major financial institutions, what we have been seeing is that they are getting severe competition from the commercial paper market and most of the focus is being directed toward the middle market lending because that is where the profits are, one of the things that we have seen in the middle market is extensive foreign competition starting to come in, particularly the Japanese.

In terms of the Japanese, they have been saving almost $1 billion a day which is coupled with a deemphasis on commercial lending in their own market because of inflationary pressures. What does that lead to?

Well, you have a number of acquisitions being made by the Japanese banks through which they are going to be able to get into middle market commercial lending. That is lending to companies with, say, over $5 million in sales up to the Fortune 500 level. They have got the money. They have the distribution capability and the desire to lend.

There is a benefit to American business. It is lower cost loans short term. However, what concerns us is simply this, over the long term control over a nation's financial institutions means control over individuals and businesses including selecting which of those are provided with credit and allowed to grow.

We see another threat in terms of commercial lending from the current regulatory environment. It is simply this: small business loans could be an unintended casualty of the new regulatory environment. Many bank officers are already running scared. You couple that with some overeager examiners, afraid of ending up embarrased because of some loans they missed, and what do we have? We have an environment where you are sometimes getting extreme regulatory pressure on some types of commercial lending. Our fear is that that regulatory presssure could further turn off credit to small business.

Now, looking at real estate. As we look at real estate, I guess the first thing about real estate to remember is that real estate is not a basic industry. It is a reflective industry. It reflects the needs for homes, offices, and other commercial space.

Also, real estate is not the basis of all true wealth. Real estate lending often appears deceptively simple particularly when real estate values are going up and everybody is out there making money. However, the important thing to keep in mind is that values are contingent but debt is forever.

Now, looking at real estate and leverage, real estate is obviously a very highly leveraged industry. Leverage works great in rising markets, but it is disastrous in down markets. So let's take a look at what has been happening to real estate loan growth in the United States. It has been the fastest growing sector of bank lending for the past 5 years.

For example, agricultural loans actually declined $4.5 billion, or 9 percent in the last 5 years. Commercial loans grew $72 billion, or 17 percent. Loans to individual grew $103 billion, or 40 percent, and real estate loans grew $272 billion, or 75 percent. You add to that some home equity loans totaling $40 billion, and you are looking at tremendous real estate loan exposure on a national basis.

Now, as we look at it, much of that loan growth reflected the real need for homes and offices, and so on. However, a chunk of that was also financing speculative excesses.

Let's take a look at real estate lending in the Northeast. Real estates in nine Northeastern States in the last 5 years grew by $110 billion, or 144 percent. We see in that growth the potential for major problems as they try to both absorb the growth in the supply of real estate and deal with declining values.

Bank regulators we feel face three major challenges with regard to real estate.

First, they must deal with existing speculative excesses in some markets.

Second, they must consider the impact on real estate values of the RTC's disposition of repossessed real estate.

And, third, they must realize that the potential exists for significant decline in the public's faith in the value of real estate.

Now, in terms of preventing speculative excesses, it is a tough job for any regulator because it means pulling away the punch bowl from the party early in the evening to the profound displeasure of all of the party goers.

On a national basis we are currently working with about 10,000 banks and 3,000 thrifts, and these are some of the things I keep hearing from them with regard to the regulators.

First, focus attention on the bad banks where the problems are.

Second—and this is probably one of the most common—get the regulators to send out more experienced examiners. This to us implies the need for more thorough training coupled with adequate compensation so that good examiners stay on the staff.

And, third, send the examiners to charm school. We are not proposing that there be federally funded charm schools for bank examiners, but some diplomacy would help.

I would add a fourth and fifth. Regulators need to have the courage to move on speculative excesses well before they become speculative disasters, even at the risk of being criticized for being too soon.

And, fifth, regulators should not discourage prudent lending to small businesses. Small businesses are the country's major source of job creation and innovation. The worst possible unintended result of the new regulatory environment would be to dry up lending to small business. In reality, bank loans are the major source of expansion capital for small businesses throughout the country.

Thank you.

[The complete prepared statement of Alex Sheshunoff follows:]

Prepared Testimony
of
Alex Sheshunoff [1]
before the
Senate Committee on Banking, Housing, and Urban Affairs
October 5, 1989

Thank you, Mr. Chairman, for inviting me to express my views on the current problems facing the banking industry and those who regulate it. My remarks will focus on real estate lending. Appended to this document is a more in-depth analysis of bank lending trends, including loan mix, growth and quality at both national and state levels.

Rapid Loan Growth

Rapid loan growth is the best leading indicator of future bank problems. Rapid loan growth will often tell you not only the specific type of loan that will be in trouble but the magnitude of the future problems as well.

Speculative Excesses

In addition to quality control problems, there is the more fundamental problem of rapid loan growth financing speculative excesses. The basic fuel for speculative excess is credit. The spark that ignites this fuel is optimism about the future. This optimism is often reinforced by the willingness of banks to make credit available — "If the bank lends money on it, it must be good."

Financial Crises

Dramatic crashes in asset values almost always follow speculative excesses — the greater the excess, the greater the fall in values. Speculative excesses lead to financial crises that ultimately may involve calling on the lender of last resort in order to bail out the system.

Speculative excesses are caused by consenting adults: willing borrowers and lenders. Frequently the individuals involved are intelligent, experienced, and well-intentioned. However, when an upward spiral in values gains momentum and increasing amounts of credit become readily available, and everybody is "making" lots of money, the potential for a major financial crisis is at hand.

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[1] Mr. Sheshunoff is president of Sheshunoff & Company, Austin, Texas. Founded in 1971, the firm provides bank information and consulting services to clients, including over 10,000 banks, 2,000 S&Ls, as well as numerous corporations, public accounting firms, and bank regulators.

I don't believe we are there yet. However, a clear potential exists for speculative excesses developing in selected real estate markets. The challenge is to slow it down sooner rather than later. The nation has already had a taste in the Southwest of what can happen when the speculative real estate bubble bursts.

The State of Bank Lending Today

I would now like to review the state of bank lending today. Our analysis excludes the obvious problems associated with LDC and LBO lending at major financial institutions.

Consumer Lending

Lending to consumers continues to be a source of great strength and relatively low risk. Even in Texas, only 1.3% of consumer loans are nonperforming[2] versus 4.8% of commercial and 9.6% of real estate loans.

Basically, the American consumer has a high level of integrity and, even in hard times, pays his debts.

Competition among major banks for this highly profitable and predictable line of business will intensify through acquisition of failed thrifts, increased marketing efforts, new products, new technology, and lower operating costs. The major consumer-oriented banks are becoming leaner, smarter, and much more aggressive. This increased competition will put pressure on the consumer-banking profit margins of all banks.

Commercial Lending

Commercial lending is growing modestly. Profit margins on large credits are thin to non-existent because, in addition to bank competition, major corporations raise money through the commercial paper market. The middle-market commercial customer (companies not in the Fortune 500 with revenues above $5 million per year), however, is a major source of bank profitability.

Foreign Competition for Commercial Loans

Japanese competition for the middle-market commercial customer will increase dramatically. This will occur for several reasons. First of all, the Japanese people are saving at the rate of $1 billion a day. However, their government apparently wants to slow down commercial lending in Japan because of inflationary pressures.

Many major Japanese banks, through strategic acquisitions, have acquired the marketing skills and physical presence that will enable them to provide low-cost loans to U.S. businesses. Thus, they have the money, the distribution capability, and the desire to pursue the middle market aggressively.

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[2] Nonperforming: past due 90 days or more and nonaccrual loans and lease financing receivables.

While this may be an immediate benefit to the business borrower, it is a major threat to U.S. banks.

What concerns us is simply this: Over the long term, control over a nation's financial institutions means control over which individuals and businesses are provided with credit and allowed to grow.

The Danger of Regulatory Overkill

Commercial lending, especially to small business, could be an unintended casualty of the new regulatory environment. Many bank loan officers are running scared, anyway, with regard to small business loans. Quite simply, excessively critical commercial loan examinations by over-eager, sometimes-inexperienced bank examiners could further turn off the credit needed to promote the growth of small business.

Real Estate Lending: The Achilles' Heel of Banking?

Real estate is not a basic industry, but rather is a reflective industry. It reflects the *need* for homes, offices and other commercial space.

Real estate is not the basis of all true wealth. In fact, real estate lending often appears deceptively simple because of real estate's perceived intrinsic value, particularly in markets that have yet to experience a reversal of the upward trend of prices.

The Ten Sheshunoff Rules of Commercial Real Estate Lending are attached to this testimony. The tenth rule is perhaps most important:

> "Values are contingent.
>
> Debt is forever."

This statement is particularly relevant because real estate traditionally has been highly leveraged.

Real Estate and Leverage

Real estate is obviously a highly leveraged industry: 10% down on a home and 100% financing on a commercial building are not uncommon. Leverage works great in an inflationary market but is a disaster in a deflationary market.

The easy availability of credit for real estate has, of course, made home ownership possible, but it also has increased the vulnerability of all real estate markets to dramatic decreases in value should credit be curtailed or to unforeseen shocks — such as a drop in the price of oil, a stock market crash, or a significant reduction in defense spending.

Real Estate Loan Growth

Real estate loans have constituted the fastest growing sector of bank lending for the past five years as compared with agriculture, commercial, and loans to individuals. From 1984 through 1988 banks' loans grew as follows:

1. *Agriculture* loans actually declined $4.5 billion or 9% from $49.8 billion to $45.3 billion.
2. *Commercial* loans grew $72 billion or 17% from $425 billion to $497 billion.
3. Loans to *individuals* grew $103 billion or 40% from $258 billion to $361 billion.
4. *Real estate* loans grew $272 billion or 75% from $364 billion in 1984 to $636 billion in 1988. Plus there was substantial growth in home equity loans which totaled $40 billion in 1988.

Much of the real estate loan growth reflected the need for homes, offices and other commercial space. Some of the growth, unfortunately, financed speculative excesses which will take time to absorb...often at significantly reduced prices with resulting losses.

It is instructive to note the rapid growth in real estate lending by banks located in nine Northeastern states. Real estate loans in these states grew $110.4 billion or 144% from $76.8 billion in 1984 to $187.2 billion in 1988.

Nine Northeastern States
Total Real Estate Loans
(Billions)

	1984	1985	1986	1987	1988
New York	$31.9	$38.7	$51.6	$64.3	$71.1
Massachusetts	7.4	11.5	18.6	24.3	29.9
Pennsylvania	16.3	17.4	21.5	25.8	29.9
New Jersey	11.4	13.6	18.5	23.8	28.9
Connecticut	4.6	5.8	8.5	11.7	14.0
Rhode Island	1.3	1.6	3.0	3.7	4.2
New Hampshire	1.6	2.0	2.7	3.5	3.8
Maine	1.0	1.2	1.7	2.3	2.9
Vermont	1.3	1.4	1.7	2.1	2.5
Total	$76.8	$93.2	$127.8	$161.5	$187.2

Future Challenges

Bank regulators face three major real estate challenges.

First, they must deal with existing speculative excesses in some markets. Arizona provides a good example today.

Second, they must consider the impact on real estate values of the Resolution Trust Corporation's disposition of repossessed real estate.

Third, they must realize that the potential for a significant downward revision in the public perception of the value of real estate exists.

Preventing Speculative Excesses

Regulating the banking system ultimately involves preventing or containing speculative excesses. It's a difficult responsibility for any bank regulator. It means pulling the punch bowl away from the party early in the evening to the profound displeasure of the party-goers.

We work with over 10,000 banks and 2,000 thrifts throughout the country. As I've met with many of their executives about regulation, three recommendations keep recurring:

First, focus attention on "bad" banks.

Second, get the regulators to send more experienced examiners. This implies the need for more thorough training coupled with adequate compensation.

Third, send the examiners to charm school.

To these, I would like to add a fourth and fifth recommendation.

Fourth, regulators need to have the courage to move on speculative excesses well before they become speculative disasters — even at the risk of being criticized for moving too soon.

Fifth, regulators should not discourage prudent lending to small businesses. Small businesses are the country's major source of job creation and innovation. The worst possible unintended fall-out of the new regulatory environment would be to dry up bank lending to small business. In reality, bank loans are the major source of expansion capital for small businesses throughout the country.

Unfortunately for the regulators there is rarely applause for a job well done but always ample blame for everything that goes wrong.

Thank you.

THE SHESHUNOFF RULES OF COMMERCIAL REAL ESTATE LENDING

1. **Be prepared to run it.**

2. **Give no credence to financial statements ... whatsoever.**

3. **Look only to cash flows not related to real estate.**

4. **If there is an abundance of collateral, "just ask for more."**

5. **Start getting out when real estate becomes a "commodity" to be speculated on.**

6. **Resolve to lose money *only* in your own trade territory.**

7. **Use referrals as a competitive weapon: Refer all marginal credits to overeager competitors.**

8. **Recognize that from the moment the commercial real estate loan is made, the lender owns the real estate; the borrower has the option to repurchase if it goes up in value.**

9. **Real estate is not a basic industry. It is a reflective industry, reflecting the need for businesses, offices, and other commercial space.**

10. **Values are contingent. Debt is forever.**

Total Real Estate Loans* for Banks (Amounts in Billions)

	1984	1985	1986	1987	1988	$ Change '84-'88	% Change '84'-'88
Alabama	$ 3.7	$ 4.3	$ 5.3	$ 6.8	$ 8.1	$ 4.4	121.3%
Alaska	1.3	1.4	1.4	1.2	1.0	-0.3	-19.8
Arizona	4.8	6.2	7.6	8.5	8.6	3.8	78.6
Arkansas	2.9	3.4	3.7	3.9	4.2	1.3	43.4
California	57.0	60.9	63.2	68.6	78.1	21.1	37.0
Colorado	4.7	4.8	5.1	5.4	5.4	0.8	16.7
Connecticut	4.6	5.8	8.5	11.7	14.0	9.3	201.5
Delaware	2.3	2.7	3.0	3.4	3.8	1.5	67.0
D.C.	2.1	2.7	3.4	4.3	5.2	3.1	147.8
Florida	18.2	21.5	27.7	33.8	39.9	21.7	119.2
Georgia	5.8	7.4	9.5	11.5	13.6	7.8	133.6
Hawaii	2.1	2.4	2.7	3.1	3.9	1.8	84.0
Idaho	1.1	1.1	1.0	1.0	1.2	0.1	6.1
Illinois	18.6	18.7	20.4	24.2	28.4	9.8	52.4
Indiana	7.5	8.0	8.7	10.0	12.0	4.4	58.6
Iowa	3.2	3.2	3.2	3.6	4.0	0.8	25.4
Kansas	2.6	3.0	3.5	4.0	4.5	1.9	71.5
Kentucky	4.3	4.9	5.6	6.7	7.9	3.6	84.3
Louisiana	6.4	7.1	7.4	7.5	7.8	1.4	22.7
Maine	1.0	1.2	1.7	2.3	2.9	2.0	206.1
Maryland	5.4	6.4	7.9	11.8	14.8	9.3	172.6
Massachusetts	7.4	11.5	18.6	24.3	29.9	22.5	302.8
Michigan	12.2	12.8	14.0	16.5	18.8	6.6	54.1
Minnesota	6.5	6.7	7.1	7.8	8.5	2.0	30.9
Mississippi	2.6	2.9	3.3	3.6	4.0	1.4	54.6
Missouri	7.3	8.6	10.4	12.6	14.5	7.1	97.4
Montana	0.9	0.9	0.8	0.8	0.8	-0.1	-12.0
Nebraska	1.1	1.2	1.4	1.5	1.7	0.6	53.4
Nevada	1.3	1.4	1.5	1.6	1.7	0.3	26.0
New Hampshire	1.6	2.0	2.7	3.4	3.8	2.1	133.7
New Jersey	11.4	13.6	18.5	23.8	28.9	17.5	153.6
New Mexico	1.5	1.8	1.9	2.3	2.5	1.0	66.6
New York	31.9	38.7	51.6	64.3	71.1	39.2	122.8
North Carolina	6.5	8.3	10.5	14.3	17.7	11.2	171.9
North Dakota	0.8	0.7	0.7	0.8	0.8	0.1	9.5
Ohio	11.4	13.0	15.2	18.7	21.2	9.7	85.1
Oklahoma	5.2	5.5	5.3	5.0	4.7	-0.5	-9.8
Oregon	3.0	3.0	3.1	3.5	3.8	0.8	26.2
Pennsylvania	16.3	17.4	21.5	25.8	29.9	13.6	83.8
Rhode Island	1.3	1.6	3.0	3.7	4.2	2.9	224.1
South Carolina	1.9	2.3	3.2	4.3	5.4	3.5	181.8
South Dakota	0.7	0.6	0.7	0.7	0.8	0.2	23.7
Tennessee	5.1	6.0	7.4	9.1	10.6	5.4	106.1
Texas	38.0	43.1	45.4	42.5	34.6	-3.3	-8.8
Utah	2.4	2.5	2.7	2.7	2.9	0.5	21.3
Vermont	1.3	1.4	1.7	2.1	2.5	1.2	93.7
Virginia	7.8	8.9	10.8	13.7	16.6	8.7	111.7
Washington	5.4	6.2	7.1	8.1	8.9	3.5	66.0
West Virginia	2.8	3.0	3.3	3.7	4.2	1.4	49.8
Wisconsin	7.6	8.0	8.6	9.8	11.0	3.4	45.3
Wyoming	0.6	0.7	0.7	0.6	0.6	-0.1	-12.2
National	$363.5	$411.3	$483.4	$564.9	$635.7	$272.2	74.9%

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* Includes construction & land development loans, loans secured by 1-4 family residential, secured by multi-family residential, secured by non-farm non-residential property

Total Real Estate Loans* for Banks
(Ranked by Dollar Change, Amounts in Billions)

	1984	1985	1986	1987	1988	$ Change '84-'88	% Change '84'-'88
New York	$ 31.9	$ 38.7	$ 51.6	$ 64.3	$ 71.1	$ 39.2	122.8%
Massachusetts	7.4	11.5	18.6	24.3	29.9	22.5	302.8
Florida	18.2	21.5	27.7	33.8	39.9	21.7	119.2
California	57.0	60.9	63.2	68.6	78.1	21.1	37.0
New Jersey	11.4	13.6	18.5	23.8	28.9	17.5	153.6
Pennsylvania	16.3	17.4	21.5	25.8	29.9	13.6	83.8
North Carolina	6.5	8.3	10.5	14.3	17.7	11.2	171.9
Illinois	18.6	18.7	20.4	24.2	28.4	9.8	52.4
Ohio	11.4	13.0	15.2	18.7	21.2	9.7	85.1
Connecticut	4.6	5.8	8.5	11.7	14.0	9.3	201.5
Maryland	5.4	6.4	7.9	11.8	14.8	9.3	172.6
Virginia	7.8	8.9	10.8	13.7	16.6	8.7	111.7
Georgia	5.8	7.4	9.5	11.5	13.6	7.8	133.6
Missouri	7.3	8.6	10.4	12.6	14.5	7.1	97.4
Michigan	12.2	12.8	14.0	16.5	18.8	6.6	54.1
Tennessee	5.1	6.0	7.4	9.1	10.6	5.4	106.1
Alabama	3.7	4.3	5.3	6.8	8.1	4.4	121.3
Indiana	7.5	8.0	8.7	10.0	12.0	4.4	58.6
Arizona	4.8	6.2	7.6	8.5	8.6	3.8	78.6
Kentucky	4.3	4.9	5.6	6.7	7.9	3.6	84.3
South Carolina	1.9	2.3	3.2	4.3	5.4	3.5	181.8
Washington	5.4	6.2	7.1	8.1	8.9	3.5	66.0
Wisconsin	7.6	8.0	8.6	9.8	11.0	3.4	45.3
D.C.	2.1	2.7	3.4	4.3	5.2	3.1	147.8
Rhode Island	1.3	1.6	3.0	3.7	4.2	2.9	224.1
New Hampshire	1.6	2.0	2.7	3.4	3.8	2.1	133.7
Maine	1.0	1.2	1.7	2.3	2.9	2.0	206.1
Minnesota	6.5	6.7	7.1	7.8	8.5	2.0	30.9
Kansas	2.6	3.0	3.5	4.0	4.5	1.9	71.5
Hawaii	2.1	2.4	2.7	3.1	3.9	1.8	84.0
Delaware	2.3	2.7	3.0	3.4	3.8	1.5	67.0
Louisiana	6.4	7.1	7.4	7.5	7.8	1.4	22.7
Mississippi	2.6	2.9	3.3	3.6	4.0	1.4	54.6
West Virginia	2.8	3.0	3.3	3.7	4.2	1.4	49.8
Arkansas	2.9	3.4	3.7	3.9	4.2	1.3	43.4
Vermont	1.3	1.4	1.7	2.1	2.5	1.2	93.7
New Mexico	1.5	1.8	1.9	2.3	2.5	1.0	66.6
Colorado	4.7	4.8	5.1	5.4	5.4	0.8	16.7
Iowa	3.2	3.2	3.2	3.6	4.0	0.8	25.4
Oregon	3.0	3.0	3.1	3.5	3.8	0.8	26.2
Nebraska	1.1	1.2	1.4	1.5	1.7	0.6	53.4
Utah	2.4	2.5	2.7	2.7	2.9	0.5	21.3
Nevada	1.3	1.4	1.5	1.6	1.7	0.3	26.0
South Dakota	0.7	0.6	0.7	0.7	0.8	0.2	23.7
Idaho	1.1	1.1	1.0	1.0	1.2	0.1	6.1
North Dakota	0.8	0.7	0.7	0.8	0.8	0.1	9.5
Montana	0.9	0.9	0.8	0.8	0.8	-0.1	-12.0
Wyoming	0.6	0.7	0.7	0.6	0.6	-0.1	-12.2
Alaska	1.3	1.4	1.4	1.2	1.0	-0.3	-19.8
Oklahoma	5.2	5.5	5.3	5.0	4.7	-0.5	-9.8
Texas	38.0	43.1	45.4	42.5	34.6	-3.3	-8.8
National	$363.5	$411.3	$483.4	$564.9	$635.7	$272.2	74.9%

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*Includes construction & land development loans, loans secured by 1-4 family residential, secured by multi-family residential, secured by non-farm non-residential property

Total Real Estate Loans* for S&Ls
(Amounts in Billions)

	1984	1985	1986	1987	1988	$ Change '84-'88	% Change '84'-'88
Alabama	$ 4.3	$ 4.7	$ 4.8	$ 4.6	$ 5.2	$ 0.9	21.5%
Alaska	0.3	0.4	0.3	0.3	0.3	-0.0	-10.7
Arizona	7.5	10.1	10.9	11.7	12.5	5.1	67.7
Arkansas	5.0	5.4	4.2	4.0	3.7	-1.2	-24.8
California	161.1	174.8	185.7	209.0	238.0	76.8	47.7
Colorado	7.6	8.0	7.0	8.0	6.4	-1.2	-15.7
Connecticut	5.8	6.4	6.9	7.3	6.2	0.4	6.3
Delaware	0.6	0.7	0.7	0.9	1.0	0.4	59.7
D.C.	1.5	1.3	1.2	1.3	1.8	0.4	23.6
Florida	41.3	45.1	43.5	41.3	45.8	4.5	10.8
Georgia	8.8	9.2	9.4	10.2	10.8	2.0	23.1
Hawaii	2.6	2.4	2.3	3.1	3.5	0.9	35.9
Idaho	0.7	0.8	0.8	0.5	0.5	-0.3	-35.1
Illinois	32.4	34.4	35.5	36.2	36.9	4.5	13.9
Indiana	7.8	8.2	8.1	8.6	8.7	0.9	12.1
Iowa	5.7	5.8	5.4	5.1	5.3	-0.3	-5.5
Kansas	6.6	7.5	7.7	7.8	8.5	1.9	28.0
Kentucky	4.9	4.8	4.4	4.4	4.6	-0.3	-5.4
Louisiana	9.2	9.7	9.9	9.7	8.9	-0.3	-3.1
Maine	0.4	0.4	0.5	0.5	0.6	0.2	59.0
Maryland	7.1	11.3	11.9	11.9	13.4	6.3	89.5
Massachusetts	5.2	6.2	6.4	7.7	7.8	2.7	51.2
Michigan	13.7	14.2	14.1	13.9	14.7	1.0	7.6
Minnesota	6.6	6.9	6.5	6.7	6.4	-0.2	-3.2
Mississippi	2.1	2.2	2.3	2.3	2.4	0.4	18.3
Missouri	12.9	13.4	11.9	12.2	12.7	-0.2	-1.8
Montana	0.9	0.8	0.7	0.7	0.6	-0.2	-24.9
Nebraska	6.2	6.2	5.8	5.2	5.0	-1.2	-18.7
Nevada	1.8	2.0	1.9	2.1	2.2	0.4	24.5
New Hampshire	1.2	1.7	1.6	1.9	1.8	0.6	49.5
New Jersey	22.5	25.0	28.2	29.8	31.8	9.3	41.4
New Mexico	2.7	2.9	2.9	2.7	2.7	0.0	0.7
New York	38.5	40.2	44.6	47.9	53.1	14.6	38.1
North Carolina	9.5	11.9	12.5	13.2	14.0	4.5	47.0
North Dakota	2.0	2.0	1.9	1.7	1.8	-0.2	-11.5
Ohio	30.2	32.1	30.0	30.5	31.8	1.6	5.4
Oklahoma	6.1	6.6	6.3	5.7	4.7	-1.4	-23.7
Oregon	4.7	4.6	4.6	4.4	5.2	0.5	10.6
Pennsylvania	22.6	24.5	23.8	25.0	27.1	4.5	20.0
Rhode Island	2.7	2.8	3.1	3.4	2.2	-0.6	-20.7
South Carolina	5.8	6.2	6.5	6.7	7.4	1.6	27.5
South Dakota	0.8	0.8	0.7	0.7	0.7	-0.0	-4.6
Tennessee	5.9	6.2	6.2	6.4	7.0	1.1	18.6
Texas	45.3	52.6	53.0	46.0	39.2	-6.1	-13.4
Utah	4.2	3.6	3.4	3.3	3.5	-0.7	-17.3
Vermont	0.2	0.2	0.3	0.3	0.4	0.1	60.6
Virginia	12.6	14.0	14.6	15.8	18.2	5.5	43.6
Washington	8.6	9.7	10.4	10.4	10.6	2.0	23.2
West Virginia	1.4	1.5	1.3	1.2	1.2	-0.3	-16.3
Wisconsin	10.0	9.9	9.9	10.3	10.9	0.9	8.9
Wyoming	0.8	0.8	0.7	0.5	0.5	-0.3	-41.6
National	$608.8	$663.3	$677.1	$705.1	$750.3	$141.5	23.2%

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*Includes loans on 1 to 4 family dwelling units, on multi-family dwelling units, nonresidential real estate and land loans.

Total Real Estate Loans* for S&Ls (Ranked by Dollar Change, Amounts in Billions)

	1984	1985	1986	1987	1988	$ Change '84-'88	% Change '84'-'88
California	$161.1	$174.8	$185.7	$209.0	$238.0	$ 76.8	47.7%
New York	38.5	40.2	44.6	47.9	53.1	14.6	38.1
New Jersey	22.5	25.0	28.2	29.8	31.8	9.3	41.4
Maryland	7.1	11.3	11.9	11.9	13.4	6.3	89.5
Virginia	12.6	14.0	14.6	15.8	18.2	5.5	43.6
Arizona	7.5	10.1	10.9	11.7	12.5	5.1	67.7
Florida	41.3	45.1	43.5	41.3	45.8	4.5	10.8
Illinois	32.4	34.4	35.5	36.2	36.9	4.5	13.9
North Carolina	9.5	11.9	12.5	13.2	14.0	4.5	47.0
Pennsylvania	22.6	24.5	23.8	25.0	27.1	4.5	20.0
Massachusetts	5.2	6.2	6.4	7.7	7.8	2.7	51.2
Georgia	8.8	9.2	9.4	10.2	10.8	2.0	23.1
Washington	8.6	9.7	10.4	10.4	10.6	2.0	23.2
Kansas	6.6	7.5	7.7	7.8	8.5	1.9	28.0
Ohio	30.2	32.1	30.0	30.5	31.8	1.6	5.4
South Carolina	5.8	6.2	6.5	6.7	7.4	1.6	27.5
Tennessee	5.9	6.2	6.2	6.4	7.0	1.1	18.6
Michigan	13.7	14.2	14.1	13.9	14.7	1.0	7.6
Alabama	4.3	4.7	4.8	4.6	5.2	0.9	21.5
Hawaii	2.6	2.4	2.3	3.1	3.5	0.9	35.9
Indiana	7.8	8.2	8.1	8.6	8.7	0.9	12.1
Wisconsin	10.0	9.9	9.9	10.3	10.9	0.9	8.9
New Hampshire	1.2	1.7	1.6	1.9	1.8	0.6	49.5
Oregon	4.7	4.6	4.6	4.4	5.2	0.5	10.6
Connecticut	5.8	6.4	6.9	7.3	6.2	0.4	6.3
Delaware	0.6	0.7	0.7	0.9	1.0	0.4	59.7
D.C.	1.5	1.3	1.2	1.3	1.8	0.4	23.6
Mississippi	2.1	2.2	2.3	2.3	2.4	0.4	18.3
Nevada	1.8	2.0	1.9	2.1	2.2	0.4	24.5
Maine	0.4	0.4	0.5	0.5	0.6	0.2	59.0
Vermont	0.2	0.2	0.3	0.3	0.4	0.1	60.6
Alaska	0.3	0.4	0.3	0.3	0.3	-0.0	-10.7
New Mexico	2.7	2.9	2.9	2.7	2.7	0.0	0.7
South Dakota	0.8	0.8	0.7	0.7	0.7	-0.0	-4.6
Minnesota	6.6	6.9	6.5	6.7	6.4	-0.2	-3.2
Missouri	12.9	13.4	11.9	12.2	12.7	-0.2	-1.8
Montana	0.9	0.8	0.7	0.7	0.6	-0.2	-24.9
North Dakota	2.0	2.0	1.9	1.7	1.8	-0.2	-11.5
Idaho	0.7	0.8	0.8	0.5	0.5	-0.3	-35.1
Iowa	5.7	5.8	5.4	5.1	5.3	-0.3	-5.5
Kentucky	4.9	4.8	4.4	4.4	4.6	-0.3	-5.4
Louisiana	9.2	9.7	9.9	9.7	8.9	-0.3	-3.1
West Virginia	1.4	1.5	1.3	1.2	1.2	-0.3	-16.3
Wyoming	0.8	0.8	0.7	0.5	0.5	-0.3	-41.6
Rhode Island	2.7	2.8	3.1	3.4	2.2	-0.6	-20.7
Utah	4.2	3.6	3.4	3.3	3.5	-0.7	-17.3
Arkansas	5.0	5.4	4.2	4.0	3.7	-1.2	-24.8
Colorado	7.6	8.0	7.0	8.0	6.4	-1.2	-15.7
Nebraska	6.2	6.2	5.8	5.2	5.0	-1.2	-18.7
Oklahoma	6.1	6.6	6.3	5.7	4.7	-1.4	-23.7
Texas	45.3	52.6	53.0	46.0	39.2	-6.1	-13.4
National	$608.8	$663.3	$677.1	$705.1	$750.3	$141.5	23.2%

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*Includes loans on 1 to 4 family dwelling units, on multi-family dwelling units, nonresidential real estate and land loans.

The **CHAIRMAN**. Gentlemen, thank you very much for your comments.

Senator D'Amato has joined us, and Senator Bryan has joined us. I afforded the opportunity earlier for any initial comments, and I don't know——

Senator **D'AMATO**. I would ask for the right to submit a statement and have it as if read in its entirety, and I have a number of questions which I would like to submit for the record.

The **CHAIRMAN**. Very good.

[The statement of Senator D'Amato follows:]

STATEMENT OF SENATOR D'AMATO

Mr. Chairman, when we look at the condition of the banking system, we must look at the legal structure that makes the system. Changes in both the domestic and international financial environments have brought us to the point where it is no longer relevant to discuss whether we should undertake major reform of the legal structure of the financial services industry. It is time to do it.

The system of finance established in the 1930's and strengthened in 1956 by the Bank Holding Company Act was designed to restrict competition among the various sectors of the industry and enhance the safety of the financial institution. We are light-years later by 1989 in terms of the structure of the banking industry. Our current bank regulatory system and today's patchwork of financial law make the banking system inherently unstable and anticompetitive.

Furthermore, the existing protections for local industries have served to undermine the efficient delivery of services and the competitive position of U.S. financial institutions in the world market.

The time has come for a broad debate and comprehensive legislation focused upon clear national priorities: stability, domestic competition and foreign competitiveness. More specifically, Mr. Chairman, the time has passed for congressional hearings, panels of variously qualified witnesses and the rehashing of well-known issues. The actions of the Federal Reserve, ratification of the Fed's actions by the Supreme Court, and the various and ingenious actions of bankers, lawyers and business people have rendered this Committee almost irrelevant to the future of the banking industry.

The time has come for Congress to create an alternative legal and regulatory structure that permits the free market rather than governmental inertia to determine which other types of businesses are compatible with ownership of a depository institution. It is time for the Congress to re-assert itself and create an efficient, rationally integrated American financial services companies to compete in the global financial services industry.

The Cranston-D'Amato-Garn banking bill would create such a structure. Let me encourage the Chairman to address this legislation.

Mr. Chairman let me mention one matter of the condition of the banking system. The thrift industry is still losing money. An institution in my state is losing $15 million a month. This institution is neither in conservatorship nor in receivership. It has sought the attention of the FDIC and not received it. Last week its depositors withdrew $50 million and each month it loses $15 million which the FDIC will have to find some day. That is the condition of the banking system. Mr. Chairman, it is a mess.

The **CHAIRMAN**. Senator Bryan.

Senator **BRYAN**. I have no questions at this point.

The **CHAIRMAN**. Senator Heinz.

Senator **HEINZ**. Mr. Chairman, I have some questions.

The **CHAIRMAN**. If you are ready, you may start.

Senator **HEINZ**. Mr. Chairman, you are the chairman.

The **CHAIRMAN**. I am a generous chairman.

Senator **HEINZ**. I will be brief. I won't look a gift horse in the mouth.

That is meant to be a compliment, I think. [Laughter.]

Mr. Chairman, I didn't hear all of Mr. Sheshunoff's testimony. I heard the testimony of all the other three witnesses. I found it absolutely fascinating. I am not sure that I was reassured by Mr. McDermott's comment when he said that the banking industry was in better shape than the thrift industry. That is a little bit like saying the United States is better off than Bangladesh.

Not to dwell on that, I was curious about the prescription, particularly of the economists, who seem to want to either give the banking system shock treatment or at least wire them up to a polygraph, as the case may be. One of the main issues seems to be the reliability of our current diagnostic techniques, generally accepted accounting principles—GAAP. What I heard them say is that there are a lot of gaps in GAAP, and they recommend that we examine market values before we get too confident and give banks a clean bill of health.

I think that there is some pretty good evidence from our witnesses that our banks are suffering from capital deficiency. This leaves the banks rather vulnerable to any chilly economic climate. I would like to ask a couple of questions in that regard because they have some fairly strong prescriptions going beyond the current minimum daily capital requirements.

One of the issues is market value accounting. Both Mr. Litan and Professor Kaufman urge the use of market value accounting. Now, we all understand why that can be valuable, particularly to regulators in evaluating a bank's financial condition and the potential exposure to the deposit insurance fund. But as we have seen, market values can fluctuate dramatically, and therefore banks' capital adequacy can fluctuate dramatically. All you have to do to get an idea of how values fluctuate is to look what happened on October 19th to a portfolio of stocks. The same portfolio of stocks that is held by everybody today, however, has a market value now well above October 19, 1987.

On October 19, 1987, we thought the world had come to an end, and apparently it didn't.

Given the volatile nature of market based accounting, are there any liabilities associated with it, and if there are, how do we take them into account in some responsible way, Mr. Litan?

Mr. LITAN. First, I advocate market value accounting as a goal. It is something that we should——

Senator HEINZ. A goal we should never get to?

Mr. LITAN. We should move in the direction of market value accounting, but I am skeptical that it can be implemented in its purest form immediately.

Senator HEINZ. Can it—let's talk about the goal. You made a very interesting suggestion—I think it was you, Mr. Litan—about using some kind of discount method of cash flow, and that is an interesting idea. Maybe we should, but let's just talk about market value accounting.

Should it ever be the basis for accounting in the banking industry and more explicitly for setting capital requirements?

Mr. LITAN. Eventually, yes. And the reason why I say eventually is that a lot of loans under the current banking environment are not traded and there is no market for them. So you can't in a pure form implement market value accounting, which was the reason I was driven to the suggestion of at least doing a discounted cash flow analysis on the loans, and that gets around the stock market problem that you pointed out.

Senator HEINZ. That is correct.

Mr. LITAN. Because you don't get the kind of 20 or 30 percent change in interest rates in 1 day or 2 hours equivalent to the 20 percent changes in the stock market.

Senator HEINZ. What you will have is a very interesting equation, though, involving judgments made by the Federal Reserve because what you proposed is that the discount factor be the bank's cost of funds.

Mr. LITAN. Correct.

Senator HEINZ. Do you suggest we use the bank's cost of funds on that very day or an average cost of funds over the last year—there are many ways of calculating it? Depending on what is going on and how you define average cost of funds, that can have a major impact on the valuation of the portfolio.

Mr. LITAN. All true. All of these things would obviously have to be—all of the details would have to be filled in through a regulatory proceeding or some kind of regulatory fleshing out.

But let me just go back to the market value point. Securities firms today account for themselves on a market value basis, and their capital requirements are based on that condition, so that eventually as banks move in the direction of holding larger and larger shares of their portfolios in securitized instruments, you are going to be moving toward a world in which you can implement market value accounting.

Senator HEINZ. Professor Kaufman.

Mr. KAUFMAN. Yes, Senator. As I interpreted your question, you were asking not only about how you could achieve it practically but should it be a goal in theory, and my answer is, yes, it should be a goal in theory because that is the only way that we can evaluate the true economic worth of these firms.

But it would force the firms, the banks, to operate somewhat differently. It would prevent them, for example, from concentrating all of their assets in a limited number of areas. It would encourage diversification, and it really gets you back to the way the banking system ran prior to the FDIC, when people had to worry about the true market values. Regardless of what was reported by the banks in those days, the depositors not being insured had all of their funds at risk, made estimates of the market value and consequently, or in the process, imposed discipline on the banks so that the banks did not concentrate all of their assets in Texas or in a particular risky area.

So, one, it would force the nature or the strategy of the institutions to change, and, two, as Bob pointed out and I pointed out in my testimony, even in as volatile a field as the equities market only two investment banking firms failed in the aftermath of the October 17th date that you referred to.

Senator HEINZ. Very well, thank you.

My time has expired, and I thank my chairman for letting me enter into the fray.

The CHAIRMAN. I would like to start with the real estate loan buildup that Mr. Sheshunoff was referring to. Looking at the data that you present on page 4 of your statement—and I wonder if the other witnesses have it as well. They heard you deliver it—as you compare the buildup in real estate amounts versus other areas, commercial loans, individuals, and so forth, it really is an extraordinary period of growth in the Northeast part of the country.

I would like you to elaborate on what are the dangers here and what should we be drawing from this. Also then I would like you to elaborate a bit, and then I would like your colleagues at the table to react to what you have said.

Mr. SHESHUNOFF. First of all, we have seen historically that rapid loan growth leads to speculative excesses. To the extent that those loans were simply meeting the real needs in the market for homes, for office space, and so on, great.

The challenge is, though, that a certain amount of it was financing speculative excesses, and now you end up with a day of reckoning with regard to that excessive growth. We have also found that people in a given market tend to speculate on real estate as being the only way often to participate in the region's growth. They can't buy all of the small businesses. So they will go out and buy some real estate, and then a lot of the real estate related financial statements that banks will see is all of a sudden you have got this great buildup, this inflation of values which has no relation to reality except at the snapshot moment in time.

The CHAIRMAN. Let me ask you this, if I may. With your experience from a Texas vantage point, where certainly there were buildups of values in a number of areas, certain factors leading up to the deflation, are you suggesting that your observation of what you see here in the Northeast looks like an equivalent profile?

There may be different underlying factors, but are you in a sense saying that we are likely to see a substantial addition in terms of softening of real estate because of these things?

Mr. SHESHUNOFF. I don't think it will be the same magnitude it was in Texas, primarily because you have a more diverse economy in the Northeast, but a lot of parts of Texas had a diverse economy, too.

The other reason I don't think it is going to be as bad is that the regulators are moving in on it sooner.

The CHAIRMAN. How bad can it be? You know, it is cold comfort that it might not be as bad as it has been in the S&L-related type situations or even banking in Texas. What do you think we are looking at as this thing plays out?

Mr. SHESHUNOFF. In Texas, nonperforming real estate loans peaked out at about 15 percent of the real estate loans and substantial charge-offs. In the Northeast they are about 2 percent nonperforming, and it is started to build up.

What happens in real estate markets, first they are flat, then they are slow, then they are soft, and then they fall off the edge.

The CHAIRMAN. Are you saying that if it is 2 percent now we are headed up to something like 8 or 10 or 12 percent?

Mr. SHESHUNOFF. I don't think it will reach 10 or 12 percent, but I think you will get up to 6, 7, 8 percent. It will vary from market to market.

I don't know, for example, if Worcester, MA, got way overbuilt, but some suburban sections of Boston clearly did.

The CHAIRMAN. Now, let me have a reaction from the other panelists that wish to react to what he said.

Do you share his concern in that area?

Mr. MCDERMOTT. I don't think there is any question that the weakest regional market at the moment, absent the Southwest, is the Northeast, and we expect to see continued announcements—certainly through the course of this year and probably through the first half of 1990 evidencing continued buildup in real estate-related problems, and some of them could be quite aggravated among commercial banks.

The CHAIRMAN. Which States seem to be in the worst condition, as you see it?

Mr. MCDERMOTT. New Hampshire is key, and then Massachusetts.

The CHAIRMAN. And so what kinds of—what are the implications of exposures of the kind that you see here that there is going to be this contraction and down draft in values? How does that roll on through in terms of what it can mean in terms of damage to individual banks or to the banks as a whole in that region?

Mr. MCDERMOTT. I think it is important to draw the distinction, as Alex did, with respect to the state of the economy, and in Texas there was a clear depression. In the case of the New England region at the moment, most of the evidence points to a massive slowdown in growth. So portfolios that were growing 10, 12 percent are now having to be conditioned to zero growth or 1 or 2 percent growth, and there has been a reaction to that and buildup in these problem assets.

I think what you would see is earnings reductions and the trauma get itself managed through and worked out because of a cessation in pressures from the marketplace; that is to say, the marketplace doesn't continue to decline but rather stabilizes, and then the excess gets worked out.

But I do think that many small savings banks are evidencing a buildup in problems for over 12 months now, and you could see some of these small banks getting into significant trouble if they don't get some help from stabilization in the economy.

The CHAIRMAN. Do either of the other two——

Mr. LITAN. I think I would add—I agree with the comments that have been given, but just to look forward, you want to know what will happen to the banks in this area.

The CHAIRMAN. What is the dimension of the risk factor or what is this likely to cause to happen?

Mr. LITAN. I cannot give you a precise estimate, but I think that Alex's point about maybe a 6-percent nonperforming loan ratio is not unreasonable. It would mean—I can't tell you how many additional failures, but it would mean some additional failures.

But more worrisome, it seems to me, is that it would weaken the capital positions of a large number of banks, and then the real test is going to be whether the regulators are going to be tough about getting capitol in those banks up or whether they are going to continue a policy of forbearance which we saw throughout the 1980's, which will allow a lot of these banks to gamble.

The CHAIRMAN. Similar to the S&L situation?

Mr. LITAN. That is right, and we have a problem that could manifest itself in the middle 1990's when the chickens come home to roost. So the acid test will be how tough are the regulators going to be to either force these banks to raise additional capital or, if they won't, not to let them pay dividends?

The CHAIRMAN. My time is up.

Senator D'Amato.

Senator D'AMATO. I have no questions.

The CHAIRMAN. Well, we could talk about that at some length, but that concerns me, and it seems to me that we are not just talking about the failure of individual banks. We are talking about a capital erosion problem that, you know, may give you a delayed reaction where, you know, we might find ourselves really dealing with that part of the problem 4 or 5 years up the line.

So it is important to think in those terms because I would like to see us rein this thing in as we go prudently and intelligently so we don't end up with a problem that overwhelms us, such as we saw in the savings and loan situation.

I also want to make a reference to the statement that you made, Mr. Sheshunoff on page 2 and 3, where you talk about the presence of Japanese banks in the American market and your belief that they are going to expand dramatically over the next several years because, among other things, they will be in a position to provide lower cost loans to the United States.

You said in your testimony that the Japanese are net savers to the tune of about $1 billion a day, if I recall your statement.

Mr. SHESHUNOFF. Yes.

The CHAIRMAN. They are generating an enormous savings pool which they can take and deploy many different ways. We of course are in the reverse situation. We have become major dis-savers. Our trade deficit alone, our debtor nation position is going up at the rate of $1 billion every 3 days just in terms of our international outstanding financial balances, and the picture isn't terribly better within the country if you look at our Federal budget deficit and other trendline deficits that we run.

But I am wondering, you imply here that what will happen is that as the Japanese financial strength comes increasingly into the American banking circles that without necessarily realizing it we would find that as a nation we might be starting to lose some of our sort of sovereign ability to deal with the credit needs and the availability of credit and who gets it in our society.

Do you want to elaborate on that point?

Mr. SHESHUNOFF. I would be happy to.

The CHAIRMAN. Then I would like your colleagues to react to that.

Mr. SHESHUNOFF. I think it is critically important that you draw the line on some kinds of foreign investment—defense companies, media, financial institutions, maybe even airlines. The way you balance the trade deficit is by selling oranges, not assets, nor banks. Banks end up controlling who gets credit and who doesn't, and the idea that a foreign-owned financial institution would then be determining which industries and which customers grew in a particular part of the country is a risk that I don't think that we need to incur.

You can draw lines and still not be xenophobic in terms of worrying about all foreigners and still be in favor of free trade and yet say that there are limits, and I think financial institutions very often are the lifeblood of certain industries. Bank loans are in effect, almost a form of venture capital for a lot of businesses. I think it is critical if we want to see small business continue to grow and grow in the direction that the government wants to see things grow, that there is no point in turning control over that to outside interests. Yet there is a very real threat that it will happen simply because they can offer loans at a lower cost and the average American business—I hate to say this—is sometimes very willing to move for a lower rate. Their loyalty factor is pretty low.

The **Chairman**. We have had some experience of that, those of us from Michigan in the automobile business, where we have seen the advent of foreign competition, and of course one of the interesting questions is what happens. The Japanese, for example, sold their cars, their Japanese-produced cars in the United States for far less than they sell that same car in Japan, despite the fact that they have to ship it over and incur the extra cost. There has always been a question if the American producers were not in the game what kinds of prices we would be asked to pay for Japanese cars. In other words, if there were a kind of market dominance, I suspect we would be seeing higher prices.

I don't want to get off into that because that gets economists stirred up, and it sort of gets into the trade situation. But I think the basic economic principles of pricing and competitive pressure do apply.

Another part of the economic textbooks, when you come to a situation where if we were to find, in the future, that we had American lending institutions impaired over some longer period of time and strong and well-positioned financial institutions from abroad that were operating in this country, whether you could get credit or what you would pay for it might change. It might change very dramatically.

And, you know, we don't like to think about these things because, just like we passed the flag amendment, we like to think of ourselves as in a permanently preeminent position. Unfortunately, you have to discipline yourself to a very severe degree to stay on top.

Let me ask your colleagues if they have a reaction.

Mr. **Sheshunoff**. One other thing. I think Treasury has had some experience with needing to consult with their major debtors, their major creditors.

The **Chairman**. We have had problems of some of the Treasury financings, as we all know, because we are hooked on foreign lending.

Mr. Kaufman, do you have a reaction? Do you see anything—I don't mean tomorrow morning, but over the next 5, 10, 15, 20 years in these trendlines that concerns you along that line?

Mr. **Kaufman**. I am not as concerned as Alex is. I think as an economist I believe in competition, and as long as you make entry into the area relatively easy, as it is now, if there is a shortage of credit in one particular area, where for some strange reason that is not profit maximization a foreign bank may not want to lend, I cannot believe that we wouldn't have a situation where other lenders are not going to enter the field, and not only bankers, but finance companies, savings and loans associations, and Merrill Lynches.

The CHAIRMAN. They have to have a savings pool. They have to have assets with which to work.

Mr. KAUFMAN. It is very easy in a competitive environment to raise these moneys from throughout the country. We now have a national money market, and that is not very difficult. And also, if you take a look at the——

The CHAIRMAN. Let me ask. Don't we have a problem where the amount that we raise isn't enough? In other words, we are consuming more capital than we are raising. So we are increasingly relying on capital from outside.

Mr. KAUFMAN. I would insist, as do a lot of foreign countries, that the foreign countries be open to American banks.

The CHAIRMAN. Japan is the critical element?

Mr. KAUFMAN. Japan is the critical element. I think it is only fair if they are permitted to operate here that we have access to their savings so that we can raise the same pool of funds and then channel it in the way that we would like to.

The CHAIRMAN. If they don't allow that, if we don't get national treatment there, we cannot compete for deposits or open for business in Japan on an equal footing. Can we therefore disconnect that part of the problem and just have a laissez-faire attitude with respect to allowing them to do whatever they might like here?

Mr. KAUFMAN. I would think that Japan is only one source of funds, but I would recommend that pressure be used in order to open it up to American banks to a greater extent. But even if we could not tap the Japanese market, while it is large in itself, it is small in relationship to the world as a whole.

Mr. LITAN. I would like to add a couple of remarks. You get economists stirred up with this kind of talk. I am stirred up.

The CHAIRMAN. I saw you moving. I could see that there was physical movement. [Laughter.]

Mr. LITAN. I will not add to what George just said, except to say that one of the fears that people have about the Japanese these days is that one day they are going to wake up and go on a dollar strike. They are going to dump all of their assets. They are going to get out of dollars, and that is going to throw the economy into a recession.

I have heard this expressed from a number of my economist colleagues who worry about continuing budget deficits, and so forth.

Well, it seems to me that to the extent these fears are valid—and I think that they are overblown—but if you are worried about them, they are certainly a lot less likely to come to fruition if they have—if the Japanese financial institutions have a stronger stake in the United States. So that is why I am a lot less concerned about their foreign investment in the United States. I think the bigger stake they have in our welfare, the more we are insulated against the nightmare that a lot of people have that they are going to desert us.

The CHAIRMAN. I have got to tell you, you can make that argument, but I think that you can shoot it full of holes as well. That is like saying if they buy us, in effect, then things are fine because they are not going to monkey with asset values, and so forth, because they are the owners——

Mr. LITAN. That implies there is some massive conspiracy in Japan.

The CHAIRMAN. It is a massive conspiracy. I think it is national interest. They have a national interest, and they feel it very keenly. It is not the same as ours.

Mr. LITAN. But the fact is that there are many different Japanese institutions that are investing in the United States. They are vicious competitors against each other, and the best insurance that we have against the kind of fears that Alex and other people have pointed out is to ensure that there is a lot of competition.

I would agree with you and thus be a lot more worried if there was evidence that there was a group of, let's say, 12 or 15 financial institutions in Japan that were all acting as one instrument, but I don't think the evidence is there. I think they are vicious competitors against each other, both in Japan and also in the United States.

The CHAIRMAN. We could have a long debate on that. Let me see if you have a reaction, Mr. McDermott, and then I will yield to Senator Heinz.

Mr. McDERMOTT. I think that there is a clear and present danger that Japanese institutions will want to expand market share in the United States over the next 3 to 5 years. About 80 percent of the profits that Japanese banks generate are generated in the Japanese marketplace, and they get very little from outside. It is only natural, given their capital position and capital strength, that they should seek out other market opportunities.

So far in the United States, the areas of focus have been primarily in California and also alliances with capital deficient or relatively capital weak U.S. financial institutions. The capital weak institutions will continue to seek out sources of capital, and they could very well continue to strike up alliances with Japanese banks.

The one thing that U.S. banks have that Japanese banks don't seem to have as good a capability at is retail banking and access to the middle market in the United States. Those are the two frontiers of lending where spreads are still respectable to some extent.

So I think it is only natural, political winds allowing, that Japanese banks will continue to start out and seek out opportunities in U.S. marketplaces. That is why in my comments I stressed the importance of industry consolidation.

The best rebuff to intrusions into this marketplace is a capital strong, profitable U.S. banking company, and I think we are seeing evidence of the emergence of superregional banks, the mergers that are announced, and they are buffers. These are the competitive responses to the intrusion of foreign banks into this country.

Senator HEINZ. Mr. Chairman, thank you.

I have got a question about the call for increased capital for banks. I think we all understand why that is very desirable. As we learned with the FSLIC, if you don't have enough capital you don't protect the insurance system, but you run the risk of so-called moral hazard.

The other problem, however, of course is that capital doesn't grow on trees just because we want it to, which is another way of saying that investors have to come up with the money. They will only employ it in a given industry if they think it is going to be profitable for them to so do.

Is there a level of capital beyond which investors will decide that returns in banking are going to be insufficient to warrant the investment capital of that kind in a depository institution?

Mr. KAUFMAN. Certainly, there is, but I don't think we are close to it.

Senator HEINZ. Where do you think the level is?

Mr. KAUFMAN. If you go back to the pre-FDIC days, you had capital ratios in banking of about 20 to 30 percent. If there indeed is——

Senator HEINZ. That is a long time ago.

Mr. KAUFMAN. It is a long time ago.

Senator HEINZ. The world is very different.

Mr. KAUFMAN. If we had introduced deposit insurance in 1900 rather than in 1933, we would see the capital ratios in 1910 be 6 percent rather than 20 percent because what the banks are doing is substituting government capital for private capital. If the returns are insufficient in a free market, then it just means that the investors do not value the banking system as much, and it should shrink.

That is what we do with the grocery industry and any other industry.

Senator HEINZ. My question is related to the world today, Dr. Kaufman. We have got international capital flows, international competition, a very different world than we had in 1933, let alone 1910, and so what I am really trying to get at is what the system can stand today. I think if we raised the level of capital requirement to 20 percent it would be "adios." The banks would say, well, we are moving to Toronto, and Bermuda, and people would conduct an electronic banking system by long distance wire.

Mr. KAUFMAN. Let me make two points.

Senator HEINZ. In this day and age there has got to be a more practical answer than in 1932, capital was 20 percent.

Mr. KAUFMAN. At one point, as Bob Litan pointed out——

Senator HEINZ. 1932, those were the banks that survived 1929; aren't they?

Mr. KAUFMAN. Those were the banks. Even in 1929, we had the ratios. I did not say 1932—I did not mean to. Certainly, deposit insurance went into effect in 1933, and we saw that the capital even then was not sufficient.

But let me make two points. As Bob Litan pointed out, what is the cost of capital? When we talk about the cost of capital, we mean equity capital. The major cost of equity capital is that it has a tax disadvantage, because the dividends are not deductible.

It would make sense to measure capital from a public policy point of view—not from the shareholders' point of view, but from the public policy point of view, from the deposit insurance point of view—as anything that is subordinated to the insurance agency. This would include subordinated debt.

Senator HEINZ. We do not measure it that way.

Mr. **Kaufman**. But we should.

Senator **Heinz**. It is irrelevant. I understand what you are saying. I understand that you are saying that common equity, preferred stock and subordinated debt being subordinated, as indeed they are, to other liabilities, such as deposits, should be counted as equity. I do not disagree with you.

But the way we measure capital is when you value the assets and you value the liabilities, and you do a subtraction. What you have left, that is capital.

Mr. **Kaufman**. That is exactly it. From the insurance agency's point of view, it is anything that is subordinated to the insurance agency, which includes subordinated debt, which does not have the cost that equity capital has. Subordinated debt allows you to deduct interest expenses.

Senator **Heinz**. I agree that stock—I mean subordinated debt—is as good as equity for these purposes.

Mr. **Kaufman**. Subordinated debt is not——

Senator **Heinz**. I am sorry, I misspoke. Do you have a comment on this, Mr. Litan?

Mr. **Litan**. I pointed this out in my testimony. You obviously have to balance considerations here, the FDIC's interest, versus the interest that you talk about. You do not want a too-high capital standard. Roughly half of the assets in the banking system today are managed by institutions with more than 6-percent capital, defined to exclude subordinated debt. Just plain all equity capital.

I think, if you look at the large regional banks, you see that as a group the regional banks tend to be better capitalized than the money center banks, and they are returning decent returns to stockholders. It seems to me that a 6-percent capital standard that will allow you to include subordinated debt as part of capital is not unduly onerous on the banking system, and it also provides a degree of protection to the FDIC that I think we need.

Mr. **Kaufman**. If I could make an additional point, if we look at the industries today that are not covered by the safety net—the finance company industry, the insurance company industry which is very similar to banking—they have much higher capital ratios.

Senator **Heinz**. Let me ask a question related to real estate loans and the qualified thrift lender test. You know, I think all of us heard your concern expressed about excessive real estate lending by banks. Yet, in the thrift bill, we adopted a qualified thrift lender test that says that a savings and loan has to meet this 70 percent qualified thrift lender test, the largest portion of which is, of course, real estate loans.

Did we do something smart, or something dumb?

Mr. **Litan**. I will jump in. You did something dumb. [Laughter.]

Not you personally, but I think this was not the direction that public policy should move in.

One of my—or actually my coauthor of the testimony, Dan Brumbaugh, did a study with Andrew Carron of First Boston that has been published. They did an analysis of thrift lending, mortgage portfolio lending over the 1980s, and calculated the cost of getting the funds and also the return that you were able to get from mortgage lending over this period, but including in the returns, or actually deducting from the returns the option value that is built into a mortgage. Because since anyone can prepay a mortgage at any time when a portfolio lender extends a mortgage he is giving an option to the borrower to actually prepay the lender. You have to deduct that value that the lender is giving away.

When you do all of that analysis, as Brumbaugh and Carron have shown, the thrift industry in doing portfolio lending was not profitable in the 1980's. The only way that they were able to make money, the thrifts were, is that they were able to gamble on the interest rates, and interest rates went down.

But over a long period of time, if you are looking over an indefinite future, you cannot assume that the thrifts will always gamble the right way.

The conclusion of their analysis is that, by locking in thrifts to 70 percent of their assets into mortgage portfolios, we are consigning them in the long run to oblivion. The simple reason for it is that, if the spreads in mortgage lending have been eliminated, or if they have been sharply reduced by securitization and so, as a result, there is not an adequate spread there between the funds' cost and the returns that you are going to get on the mortgage portfolio lending to justify a 70-percent QTL——

Senator HEINZ. How does the point you make about the option costs factor in there?

Mr. LITAN. Well, what it means is that when I extend, as a thrift, when I extend a mortgage to you at 10 percent then——

Senator HEINZ. I understand what you said, I am just trying to make it clear on the record how it all fits together.

Mr. LITAN. It reduces the economic rate of return that you can count on, because you cannot count on 10 percent forever. That person may prepay it when rates fall to 8 percent.

Senator HEINZ. Can I put it more in a layman's way? That is this: If a bank extends a mortgage at 10 percent and the cost of funds is 9 percent, and their spread is, let's say, 1 percent, you are saying that it really is not 1 percent, because the borrower has the option of prepaying. That is in effect reducing the expected value yield of that.

Mr. LITAN. That is right.

Senator HEINZ. And that cost does not show up properly when S&Ls or banks do their accounting.

Mr. LITAN. That is right. So the resulting spread that you have is less than 100 basis points, and the cost of running the thrift is more than 100 basis points, roughly speaking, in your example. So that when you do the numbers right, the profit is not there in the long run. In the short run it may be, if you gamble on interest rates and things work out; you can make money.

Senator HEINZ. Thank you very much.

The CHAIRMAN. Let me ask on that very point, because we have had a lot of witnesses on that. I remember one of the savings and loans that is very successful in Kansas. You may be familiar with it. They do a lot of mortgage lending, but they engage in all kinds of interest rate risk transactions that deal with precisely that problem.

That study that you referred to, is that based on some actual number of people actually coming in and liquidating their mortgages early? Or, is it an assumed figure that might happen over a period of time?

Mr. LITAN. It is based on a calculation procedure that is predicated on actual behavior, but it is an aggregate industry average, a calculation. They did not do it from one institution, but they looked at returns from the industry and took in option values on an industry-wide basis.

The CHAIRMAN. Would they then have taken, say, one million loans, and found that of the million loans 100,000 of the loans were cashed in within 5 years, or 7 years, or 10 years? Were they working from a broad base of actual experience?

Mr. LITAN. Yes.

The CHAIRMAN. So that is what it is based on? There is no judgment call, other than the actual experience base and some base period?

Mr. LITAN. Correct.

The CHAIRMAN. I would like to see that.

Mr. LITAN. I would be happy to provide the study.

The CHAIRMAN. As I am sure you also know, and I want the record to be clear on this, the 70-percent QTL test is not just home mortgages.

Mr. LITAN. Correct.

The CHAIRMAN. So we should not leave that impression.

Let me ask you this. We found in going through the S&L situation that we had a major problem with State powers, where States could allow activities to go beyond what were federally authorized; and yet it was all connected to Federal deposit insurance.

In the area of direct investment, that led to some of the major losses that we saw in the States that were hammered the hardest. We also saw it in junk bond holdings, where the hammering has been less to date, but may increase with time.

We found, for example, that on the Federal level Federal S&L's under the preexisting law could have up to 11 percent of their assets in junk bonds; whereas the California law allowed California thrifts to go up to as high as 40 percent.

That has been changed. So nobody can have any junk bonds in the future, and those that have them have to divest over a period of time. But I would ask each of you, do you see any problem in terms of State powers, in any number of States, that would give you a concern that States have gone into some type of activity that would create a risk profile or an exposure profile that leaves you feeling uncomfortable? Do you see anything that would in general be analogous to what we found in the S&L situation?

Mr. KAUFMAN. Let me start. What occurred in the S&L situation, of course, was that the States did not bear the cost of the failures. It was borne by the insurance company, which is some of the same differences that we see now between Seidman and Clarke, because the loss is not borne by Clarke, it is borne by Seidman. So everybody who does not bear the cost has an incentive to encourage as liberal a view as possible.

I think it makes a great deal of sense to have the insurer set out the ground rules. But I think it also points out the importance of using capital and closure. If you force the institutions to play with their own funds, and you say once they have played with their own funds and have used them up they are gone, then you can give them the freedom to do anything that they want.

The CHAIRMAN. I agree with that, but here is the problem that I want to get a precise reading on, if you can help me. That is, are there situations out there now where state powers have been exercised in a way that would create a risk profile, that perhaps we have not fully identified, and that we had better take a closer look at?

When the State regulators come in, as they will—they will be following along here in a few days you know—they would like to have an absolutely wide-open game. Because, as you say, it is the Clark and not the Seidman equivalent. As long as someone else has to pick up the tab if things go the wrong way, they would like to have the flexibility to be competitive and to do things that they cannot do, like the next-door State.

Do you see anything out there, in terms of State power for banks, that conceivably would set us up for a major problem, that we have not identified?

Mr. SHESHUNOFF. Mr. Chairman, there is a fundamental problem. That is the risk-reward ratio on a loan. When banks win on a loan, they win 4 percent over their cost of funds. When they lose, they can lose 100 percent, plus attorneys' fees. So there is the need often to want to have part of the equity.

The problem is that when a borrower is ready to bring in a bank as an equity partner, it is because they have often exhausted a lot of other equity partners, and the bank does not often have the skill to act as an equity partner that another investor might. The underlying difficulty is that the bank does need broader powers in order to generate income.

Insurance has got to be a classic example. Probably, it makes a great deal of sense for banks to be involved in selling insurance; but in terms of underwriting insurance and putting the bank's capital at risk, my thought is, no way. So I think it is important to keep drawing that line as to what makes sense for the bank to be in, versus what may be more risky and hence putting the bank's capital at risk.

Often, as with insurance, they do not have to get into the risky part of underwriting, but they can get into the distribution or selling part.

The CHAIRMAN. I guess I am hearing from each of you, those who are answering, and those who are not, that we do not have, insofar as you can judge professionally, a problem out there with State's powers being used or potentially abused beyond what we envision is national ground rules that would pose a special risk to the deposit insurance fund.

Mr. LITAN. Are you open for a two-handed answer on that? I know economists are always criticized for being two-handed.

The CHAIRMAN. When I can get an economist just to give me a two-handed answer, I figure I am ahead of the game. It is usually a six-handed answer, a ten-handed answer. [Laughter.]

Mr. LITAN. The issue of dual banking lends itself to giving a two-handed answer.

On the one hand, I think it is kind of crazy, if you take a man-from-mars view of our banking system, that we have a Federal insurer and we have 50 separate States setting 50 different rules about what banks can do. And sure, there are States like California, like Texas, like Florida, just to name a few—there are others out there—that have given their banks and/or their thrifts broader powers than national banks. And yes, the broader powers seem to be concentrated, or at least to provide opportunities in real estate lending, commercial real estate lending, and so forth, that have higher loss ratios than other kinds of loans.

So to that extent, yes, there are concerns that are raised by broader powers that the States have granted.

On the other hand, we have a number of very constructive movements that have been made at the State level because of the paralysis at the Federal level, by innovative States. The States were the first to come up with interest rate deregulation in the form of NOW accounts. They came up with interstate banking because of a paralysis at the Federal level.

In a certain number of areas, like in selling insurance—and I agree with Alex—or in selling securities, the states have, a few of them, have been innovative.

The CHAIRMAN. Let me stop you. I think the two examples you cite—and they are interesting ones—are not really powers examples, I would say. They are business innovations, but they are not in effect moving money into quite different kinds of investment operations. I mean, a NOW account is really slicing up the depositing operation in a different way.

But I am thinking more in terms of where the assets of the bank are placed.

Mr. LITAN. I agree with you. But the example is relevant, because it shows how in some areas the States were able to move, and the feds, for whatever reason, were not.

So there is a virtue in the dual banking system, given the fact that at the Federal level, for a combination of reasons that you of course know better than I, there seems to be some kind of paralysis on major fundamental policy issues.

The CHAIRMAN. But if the two examples are useful ones—and I accept them because I think they are meaningful ones—they are sort of worth process examples. They are the process of whether you affiliate across State lines. They have to do with whether you change the nature of the account.

The NOW account is a variation on a theme, in terms of what banks generally do anyway. That is very different than getting into equity investment and real estate, or deciding that junk bonds can be a very substantial portion of asset investment, or what-have-you.

I am zeroing in more—I can see that the innovation allows innovation lots of different ways. But I am really concerned about the question of whether we allow powers of innovation—I guess what I really want to call it is sort of asset deployment innovation, beyond the Federal standard, when the backstop is the Federal Deposit Insurance Fund.

I think not just the man-from-mars, but the man from any city in America would say Federal deposit insurance, Federal rules period; and if the States want to go beyond that, well you insure that. You want to add something now, you want to add five or six other things that have a different profile in terms of putting money at risk and investing money, then let the State undertake to insure that.

I am not too excited about that idea, because we have had some problems in recent times of States trying to carry out insurance functions in the banking area. But I do not see why the Federal Government ought to be on the hook in terms of the deposit insurance risk for activities that go beyond what are federally authorized. I mean, I really——

Mr. LITAN. Let me expand on that. I share your concerns. Again, if you could wipe the slate clean, and you could accept the premise that it will be productive for banks to be in certain other activities because of economies or what-have-you, I personally agree with the Fed that it is undesirable for those activities to be undertaken directly out of the bank or even the subsidiaries of the bank, because of the concerns that you have raised. The Federal insurance system is on the hook for those other activities.

So I would prefer to see those other activities outside the bank, in the form of a holding company. That would be the preferred route to go, for the reasons that you talk about.

The only credit that I would give to the dual banking system, or to states, is that—again, because of the paralysis at the Federal level—there could be gains from innovation at the State level from authorizing these activities directly out of the bank. But that is not my preferred solution. I think the broader powers ought to be exercised in a holding company.

The CHAIRMAN. Let me ask you this. How do you think the regulators these days are doing? Are they doing a good job? Are they up to the task that needs to be done here? If not, what more needs to be done?

Mr. SHESHUNOFF. First of all, I think, by and large, from what we have seen, they are doing a good job. Where they are hampered is in terms of experienced examiners to go out and get the job done.

Unfortunately, the only way you will get experienced examiners is through time. It takes time to train the examiners and to get them out there so that they are doing a good job.

We are seeing some things, in terms of the questions they are asking on management policies and procedures, that I would hate to have somebody ask me whether we are following ours that well internally. Some of the regulators are really digging in, particularly at the OCC, in terms of what is behind the decisions the bank is making. Are they following bank policy. Not only whether the banks have them, but they are asking the banks questions in terms of whether they are following the written policies.

So I think they are getting down to a level, as we peel away the onion, where they are really getting into the core.

The CHAIRMAN. You feel pretty good about the regulation that is going on out there. Mr. McDermott?

Mr. MCDERMOTT. I would agree, and add that it appears as if the regulatory approach is becoming more anticipatory than reactive. By that, I think it is pretty clear that the regulators have been sending signals for some time now that, for example, the northeast is weak in terms of real estate. For instance, the recent Bank of Boston announcement of a major provision earlier this week.

It was indicated to me that there was a regulator on-site for some period of time. It is not uncommon in large banks. The process is being looked at in anticipation, rather than in reaction to it. I think that is important.

Also, I sense a very strong willingness on the part of the various regulatory authorities to interact more closely with the marketplace. They are making more visits to Wall Street analysts, and talking about how market discipline works and what they should be looking for.

This was my experience last fall with the leveraged buy-out information. A year ago, banks told us nothing about the leveraged buy-out business. Today, we are starting to get more information. It is not enough, but we are starting to get more information.

The regulatory authorities are trying to come to grips with the aspects of the leveraged buy-out lending. We have all gone up the learning curve in the last 6 to 12 months, and it is to their credit that they are looking at issues in anticipation, instead of just reaction.

The CHAIRMAN. On the leveraged buy-out issue and the degree to which bridge loans and other financing activities are involved in that, is that a source of particular concern to any of the four of you that you would comment on?

Mr. MCDERMOTT. I think it is extremely important that there be better disclosure. The disclosure process is evolving, but I think it ought to be picked up.

We do not know when the economy might change, or when there could be a severe recessional environment. Banker protestations notwithstanding, I think we need more information. We need information not only about the extent of the activities, but the different layers of involvement that banks have.

The CHAIRMAN. Why would they object to that? What possible reason? You know, you could say, "I do not want to take the time to provide the information" but——

Mr. MCDERMOTT. There are extraordinary demands on the information process at banking institutions alone. One of the things that has irked me for years is that there are requests for more information, but never an examination of the utility of the information over time.

So for example, in some quarters we still ask banks for inflation accounting information where it has very little relevance. But today, we need information on leveraged buy-outs, and the reaction is slow.

Second, for competitive reasons they have tended to be reluctant to disclose too much. That is unfortunate, because it has been my experience in this business that when banks get in front of a problem the market tends to be more tolerant of the corrections or the losses that may occur in that area than they are if the Wall Street Journal beats it out of them.

I saw this happen with lesser-developed countries, with that situation. When the Mexicans defaulted in 1982, it took 2 years and two accounting bulletins before we had accounting information from banks. I think the same thing is happening with leveraged buy-outs. We need apples-to-apples comparisons among banks, if we are to better understand the complexity of this problem.

The CHAIRMAN. I am with you on that. What should we ask for? How should we go about doing that?

Mr. McDERMOTT. There are a lot of definitional issues that need to be sorted out. It is not an easy task; it is a complex one; but some commonality in the definitional process so that a bank in New York and one in Chicago are both talking about the same types of portfolios.

We have got leveraged transactions, we have got leveraged buy-out situations. There are differences of emphasis, differences of degrees. My strong sense is that when we look at leveraged buy-out activities from one bank to another, we are not looking at the same thing.

Second, I think the layers of involvement. There is a fair amount of—millions of dollars of equity, investments held at holding companies in blind leveraged buy-out funds, like KKR and so forth. There is I think considerable risk if those funds run into difficulties.

What we are witnessing today we feel is not a systemic risk in the form of LBO problems; but rather of deals poorly constructed with overgenerous assumptions on buy-outs or cash flow. There has been an increase in 1989.

If you talk to a banker and you say, "In 1988 we had no losses in leveraged buy-outs," in 1990 he will not be able to say that about 1989. Let's hope things do not get worse.

Mr. LITAN. A couple of points. There are several tables, if you combine the testimony, indicating that for the money center banks leveraged buy-outs have become as important if not more important in terms of their balance sheets as LDC debts in relation to equity.

It seems to me that this reflects a long-term process in the banking industry whereby at least the money center banks, having lost their best customers through the commercial paper market so that they no longer can lend to those guys, are naturally, because of the securitization process, driven to lend to customers and to deals with higher spreads.

So real estate lending is one where you get higher spreads, and LBO deals of course have high spreads and high front-end fees, and they carry higher risk. It is precisely in the money center banks, with few exceptions, that we have undercapitalization, at least by our definition, below 6 percent. A lot of the money centers are in the 3 to 4 percent range, and they would be even lower if you had higher reserves for their LDC debt in the case of institutions that have not yet increased their reserves.

So in other words, you have a concentration of higher risk among institutions that are probably undercapitalized. In that sense, it is an worrisome. It is not something where you worry that the system will crash all at once, but it represents an exposure out there that regulators have to be concerned about. Therefore, it demands the kind of information that Jim has been talking about.

The CHAIRMAN. You made a suggestion earlier that the banks ought to get into the insurance business; not underwriting, but the retail sale of insurance was, you thought, an appropriate add-on activity that presumably does not bring an unusual risk profile with it.

Do any of the others of you have suggestions to make as to the things that banks ought to be considered to be eligible for, so that maybe they do not feel so much pressure to reach into areas like leveraged buy-out activity.

Are there other avenues that we should be considering trying to create that may be carrying opportunities for sensible concentration and profitability that do not bring an unusual degree of risk with them?

Mr. KAUFMAN. I think one has to be careful when one talks about risk. Any one activity by itself could be very risky, and a bad manager could put all of his eggs in one basket and collapse the institution. Good managers would use these different risks to diversify their portfolios, and that is why it is hard to say that any one activity is risky or is not risky.

The CHAIRMAN. I think Mr. Litan's approach of using spreads—a spread is sort of generic—if there is competition, if you get a big spread, there is more risk. That is the reason.

Mr. KAUFMAN. Not only the spreads, if you take any new activity, such as direct investments for the S&L's, and put all of your assets into that, that makes that institution very risky. If you diversify with a whole host of different types of activities, you reduce risk. Any one activity can be used by good managers well. And by poor managers, even if it does not look risky, they can taint the institution.

The CHAIRMAN. You will try to have diversification that deals with that kind of risk. The banks would like to get into new lines of activities. What I am asking you is, do you see any areas that prudently ought to be considered as areas that they might move into that would fit a sensible profile and not bring undue additional risk to the deposit insurance funds, and so forth?

Mr. LITAN. Two points. One, in general, if I had my druthers, I would like to see a framework whereby politicians do not make the decision about which activities banks go into, but they set up a framework that would freely allow them to do any activity they wanted, as long as the bank itself was protected and the FDIC was protected against loss. Now, George and I and several other people——

The CHAIRMAN. How protected?

Mr. LITAN. I would suggest—we just came up with a document in Brookings with seven coauthors where we suggested a framework whereby a holding company would be allowed to go into any activity as long as the bank on some reasonable schedule converted to what we call the marketable bank, or at least had its assets in marketable instruments, so that the bank could be market valued and you could have a system whereby the regulators could take it over at a moment's notice and you would not have a lot of argument about the value of the bank. I can provide copies of that report to you.

But if you want to get into the game of choosing a particular activity, it seems to me that highest on the list, at least on my list, would be insurance agencies. I did an extensive study several years back of this whole question. I concluded, even though the evidence was relatively thin, that to the American consumer the greatest benefits of expended powers clearly lie in banks being able to offer insurance through an agency system.

Insurance is generally, for most customers, a plain vanilla product. It is not complicated. We have a very inefficient system for distributing insurance in this country, and it seems to me that banks through their existing branch network would easily be able to offer insurance at lower prices.

Second on my list would be the Proxmire-Garn bill; namely, full-service securities underwriting. Again, through a separate affiliate. But to the American consumer I do not think in the aggregate the benefits from securities underwriting would show up to anywhere near the same amount as you would see if you had insurance agency being conducted by an affiliate of the bank.

I want to reinforce what I said earlier. I prefer for all of these activities to be undertaken by affiliates, and not by an institution that is on the balance sheet of the bank.

Mr. SHESHUNOFF. I think it is important that what we are talking about here is driving more revenue through the existing overhead, hopefully risk-free revenue. The challenge for most banks is not having a laundry list of powers. They need a sales culture.

You give everybody insurance powers tomorrow; but unless they are ready to go out and hustle the business, they are not going to get any, it is not going to produce any additional earnings. Terrific, we have given them additional power, but until there is a sales culture in place, a lot of this is just a discussion and a lot of conversation.

Often, even where they have the power to get into insurance, they have not been that successful because they do not have the sales culture in place, and insurance has to be sold. We all do not go down and say, "Hey, I would like to have some insurance." Somebody has to actually contact us and sell the insurance.

The CHAIRMAN. Let me just conclude with this question. When you look ahead—and you have all in a sense covered this in one form or another here, but I would like to pull it out in an abstract, if I can—when you all look ahead over the next 2 years, 5 years, 10 years, in American banking, I would like to have each of you say again what is the single thing that is of greatest concern to you now. And if you have a real sense of urgency, to suggest that something be done to strengthen the system or to improve the system, I would like us to understand precisely what that is.

Mr. KAUFMAN. I think the greatest urgency is the lack of capital and the discretion of the regulators to forbear if capital falls below the minimum levels that they set. My recommendation, consequently, is that more capital is better than less. You have to give the regulators, or force the regulators to have, mandatory powers to recapitalize an institution once it falls below a certain positive capital asset ratio and before losses are taken by the insurance agency.

The CHAIRMAN. How serious do you think the capital inadequacy problem is at the moment?

Mr. KAUFMAN. I think if we see any shock, a portion of the shock that was in the S&L industry, we might see some very large-scale and serious losses in banking. It depends on the future of the economy. But we should not wait until the shock occurs, we should prepare for it now.

Mr. LITAN. I agree with that. I would just add the following long-term observation. As I said in my testimony, we have lower capital levels on average in banks today than we did 20 years ago when our economy was a lot more stable and there was a much more regulated banking system.

Now, if we look out over the next 10 years, we are going to have even more competition. Banks are going to face even stiffer competition, not only from domestic financial service enterprises, but from the Japanese and Europeans.

It seems to me that the more intense competitive environment, coupled with an economy that is likely to have its ups and downs, demands that we have the kind of tough capital standards that George has talked about.

I add to that one final concern. The securitization process which has revolutionized Wall Street and banking will continue over the next 10 years. More and more loans will be securitized, more and more high-grade borrowers will be driven away from banks to the securities markets. The banking system as a whole will be shrinking relative to other financial intermediaries and also to the securities market.

So the banks themselves will be left financing probably riskier and riskier types of borrowers, which is a further reason to demand an adequate capital cushion against the fluctuations that can cause bank failure.

Mr. MCDERMOTT. I would agree that more capital is better than less, but I do not agree that the levels of capital in the industry are life-threatening if in fact shocks were to hit the system. I think the system has been very resilient over the decade of the 1980's when considerable shock has been visited upon it.

We talked about rolling recession. This industry has charged up considerable sums of money because of the excesses caused by the shift from high to low inflation. I am more concerned about the competitive position of U.S. banks globally. There is no question that the trend toward globalization on many levels is continuing, whether it is investment, or whether it is expansion of services distribution.

At this stage of the game, and probably for the foreseeable future, there is only one U.S. bank that has the capacity to provide global financial services, and that is Citicorp. I do not see the emergence of another Citicorp any time soon, even though I am heartened by the prospect that there will be further consolidation of well-capitalized U.S. institutions in the form of superregional banks.

What I certainly hope occurs is that there be not only interregional combinations, as we have seen over the last 5 years, but crossregional combinations that diversify the risks of those institutions.

That will still not answer the question of global competitiveness, and they have to compete against institutions that have a global mind-set, whether they be Japanese or European institutions.

Mr. **Sheshunoff**. Going back to my testimony, real estate we feel is potentially the achilles' heel, because the values are very contingent; the debt is forever.

The other area of principal concern is, as banking gets into trouble, bankers tend to hunker down. It is tougher and tougher for small businesses to get the loans that they need.

Our greatest concern right now is that we do not stifle small business, that we continue to get the capital there, in the form of loans, because in reality most businesses do not have access to venture capitalists but they do have access to a banker. It is important that bankers still be willing to step up and make that loan. It may be a little higher-risk loan, but one that hopefully creates the next Digital Equipment.

The **Chairman**. Gentlemen, thank you very much. I appreciate the testimony. I am sorry for the interruption for the votes this morning.

I am going to also provide some questions for you to respond to for the record. Some of my colleagues have questions that they were not able to come and address directly. You have been very helpful, and we are appreciative.

The committee stands in recess.

[Whereupon, at 1:14 p.m., the committee adjourned.]

OVERSIGHT HEARINGS ON THE CONDITION OF THE BANKING SYSTEM

TUESDAY, OCTOBER 17, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Graham, Wirth, Bond, Mack, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

Let me welcome all of our guests in the audience today. I gather we have some people from the Close-Up program that are visiting the committee this morning and we are delighted to have you and certainly our witnesses as well.

I will in short order make an opening statement on the subject that we are here for this morning.

Before doing so, let me just make an observation about the activities in the financial markets yesterday. I think the day went remarkably well given the difficulties on Friday and the apprehensions coming into Monday, but I think the market system performed well yesterday in the face of heavy stock volume. No one can today predict in any meaningful way where the market may be tomorrow, let alone 10 minutes from now. That's a matter of continuing concern about the volatility in the market and whether or not there are sufficient mechanisms in place to deal with the new kinds of contingencies that seem to be present.

I want to indicate that we will be having Secretary Brady before the Senate Banking Committee on the 26th of this month, to talk about financial market reform issues. As is known, Secretary Brady headed the task force that analyzed the 1987 stock market crash and made several recommendations, most of which were not adopted by the Reagan administration or implemented in any way. A few were implemented in some form but many were not.

In any event, we will have a timely opportunity to review that on the 26th of October when Secretary Brady visits the committee.

On to today's subject, this is the second of the committee's 3 oversight hearings scheduled now on the condition of the banking industry. We have had a number of bankers from across America in town today and the last several days for ABA meetings, so it's timely that we should be taking up banking issues here.

For we will be hearing today from a distinguished panel of banking regulators from the States of California, Connecticut, Florida and Texas.

Our next hearing, which will occur on the 25th of October, we will have the Federal banking regulators in for their perspective.

In light of the past problems in the thrift industry, we are particularly interested in our panel's view today on expanded State powers. In the thrift industry the case was clear-cut. Losses in 1987 and 1988 were very heavily concentrated among State-chartered S&L's, particularly those in Texas and California.

Abuse of excessive State powers contributed very substantially to these losses.

For banks in the States represented on our panel today, the case is less clear. A disproportionate number of the banks in Florida and California that have no or low equity capital are State-chartered. These States have given their banks broader powers than many other States.

The reverse is the case in Connecticut and Texas where a higher proportion of national banks are insolvent or under-capitalized than are State banks.

The committee wants to be assured that any future losses to the bank insurance system will not be caused by expanded powers, existing or proposed, exercised by State-chartered banks.

The committee also wants to make sure that the State regulators have the tools they need to do their job well and that the State banking departments can pick up the slack being created by the FDIC's transfer of resources to resolving the thrift problems.

Finally, the committee is interested in hearing from each of the panelists the following: Whether there are any insolvent and undercapitalized State-chartered banks operating in their respective States; whether their banks capital and earnings are strong; whether their State is troubled by risky loan concentration in real estate or in leveraged buyouts; and looking several years ahead, what the panel thinks will be the future of the dual banking system as we adopt regional banking compacts and move toward full interstate banking.

I very much want to thank our witnesses for being with us today. I will in due course call on Senator Mack to introduce the Comptroller from the State of Florida, but before doing that, let me call on my colleagues for any opening comments. Senator Mack.

Senator MACK. Nothing other than to introduce him.

The CHAIRMAN. Let's wait with that. Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman. I'm very pleased you're having these hearings. I think they are very timely and as we see with some of the news recently on what's happening to U.S. banks in a competitive world, it's very important that we understand better the solidity of these institutions.

It seems to me that there are at least three fundamental issues, and you alluded to all of them in your opening remarks.

One is the issue of expanded powers. Are we getting ourselves in the banking system in to the same kind of troubles that we got into in the S&L's by providing expanded powers? I don't know. I was not one that voted for Garn-St Germain in 1982. I didn't think that was the right thing to do and I hope that in your testimony you all will be addressing the issue of troubles with expanded powers.

The second issue is capital requirements, which you also alluded to, Mr. Chairman. There's an ongoing debate between the FDIC and the Comptroller of the Currency, as you know, as to what those capital requirements ought to be and we would like to have your views on that. Should they be the 3 percent proposed by the Comptroller or the 6 percent proposed by the FDIC?

Third, do you all have the regulatory tools that are necessary to do the job? We went through a period in the 1980's of suggesting that the less regulation the better, and I think it proved to be a quite made rush to the bottom and are there items that you ought to be provided, are there tools that you should be given through Federal legislation, through action by this committee? We would like to hear from you on that.

So those three issues, Mr. Chairman—expanded powers, capital requirements, and regulatory tools are at least three of those that are right at the top of the agenda.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Wirth.

Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman. I have two other committees going, but I am very interested of course in the overall banking system. I am very interested in how this filters down to the small town community bank and smaller institution.

In my State most of the people depend on a small, frequently independently owned bank. I know that is not the big picture to everyone but it's the big picture to me and to many Americans. I'll try to get back to try to get some emphasis on the small town bank.

The CHAIRMAN. Thank you very much, Senator Pressler.

Senator Mack, would you like to introduce Mr. Lewis at this point?

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman. I appreciate the opportunity.

As a number of you know, I was in the banking business and spent 16 years in community banks starting in the mid-1960's, spent at least half of my time in a State-chartered bank. Gerald Lewis was elected I think in 1974, if my memory is correct, so we had some overlapping there before I went off to national banks.

He's been in public service in Florida since 1970 and he has done an admirable job, especially when you consider the impact of having to deal with financial institutions in a State that has been growing as rapidly as the State of Florida. And unless you've gone through that experience where you have to work with the additional problems that are created by such rapid growth, it's indeed a pleasure for me to welcome him and to introduce him to the rest of the committee.

The CHAIRMAN. Thank you, Senator Mack.

Before we begin, I have statements from Senators Dixon, Sanford, and Heinz.

[The statements from Senators Dixon, Sanford, and Heinz follows:]

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the condition of the banking industry. I look forward to the testimony from State banking regulators.

During this series of hearings, I will be looking for new insights into how the banking industry and its State and Federal regulators measure and analyze risk. In the end, our regulatory and deposit insurance systems are designed to identify and manage risk. Yet, regulators were slow to see the risks in the thrift industry and to address them promptly; indeed, some deregulatory steps were taken which made the situation worse.

We need more sophisticated ways to measure and to anticipate risk. Risk-based capital standards are being implemented, but that likely is not enough. We need a more finely calibrated scale, and we need to test its accuracy more frequently. Risk-based deposit insurance may be needed; implementing such a proposal will depend on better analysis of risks in individual bank portfolios.

What risks can banks hedge against? How should we regard banks which do hedge against interest rate risk? Have we historically overestimated the risks of securities underwriting powers? What new shocks to the system are we not now accounting for? How can we best minimize risk without regulatory overkill? I hope that these hearings will begin to answer these questions.

STATEMENT OF SENATOR TERRY SANFORD

Thank you, Mr. Chairman. I appreciate your efforts in calling for this hearing and would like to welcome our panel of distinguished State bank regulators.

Certainly if we learned nothing else from the FSLIC crisis, we learned that we need to examine the true condition of all our financial institutions—both federally and State-chartered—before problems reach overwhelming proportions. We also learned some painful lessons about the problems that can arise when there is too great a gap between the agency who regulates the institutions and the agency providing the insurance. I am glad that we have the opportunity to hear today from some of the regulators responsible for overseeing our many State-chartered institutions.

I come from a State that has done very well under our dual banking system. We have not had a bank failure in my State since the 1940's and State-chartered banks in North Carolina are allowed to engage in a very broad range of activities. However, I think North Carolina has not, as our thrift industry did, confused deregulation with desupervision. While our banks can perform a wide variety of financial services, they are carefully monitored and examined often. We need to make sure that a similar emphasis on supervision exists throughout our financial system.

Despite the strong position of the banks in North Carolina, I share many of my colleagues' concerns regarding the overall state of the industry—both large bank holding companies and smaller, community banks. We must ensure that our banks are strong and safe if they are to compete in today's global marketplace. In making sure that a sound banking system is in place, it is clear that we must look at the capital adequacy of all our financial institutions, the risks associated with expansion into LBO financing and continuing concerns over LDC debt, and the need to make sure that the recently enacted increase in bank premiums are sufficient to ensure a sound insurance base for our institutions.

Again, I thank our witnesses and look forward to their testimony.

STATEMENT OF SENATOR HEINZ

Mr. Chairman, I join you in welcoming today's witnesses—bank regulators from four States—as this committee continues its hearings on the condition of the bank industry. If my memory of our hearings on the savings and loan crisis serves me correctly, I suspect that the States represented here today—Texas, California and Florida—may not have been chosen entirely at random. In light of the current condition of the real estate market in the Northeast, I can probably guess why Mr. Brown from Connecticut was invited as well. Given the composition of today's panel I was surprised that the picture of the State banks contained in their testimony is turning out to look more rosy than red.

But regardless of how the picture develops, it must clearly be placed within the framework of the dual banking system. Under the dual banking system, States have the right to grant financial institutions broad powers. However, as we learned from the savings and loan crisis, if losses result from the use of these powers, the Federal Government—as the only deposit insurer—must pick up the tab.

I support the dual banking system. The States have served an important role as a laboratory for innovation in financial services. But without the proper mix of Federal and State safety regulations, losses in federally insured institutions can explode. As we now know, the fallout from such an explosion will not only damage the industry—but the taxpayer as well. Mr. Chairman, as these witnesses discuss the condition of the banking industry, I hope they will also address the state of the dual banking system. I am interested in exploring how the Federal and State governments which play different roles, can work together to achieve a common goal—a safe and sound banking system.

The **CHAIRMAN**. We also have Mr. James Gilleran, who is superintendent of banks from San Francisco; Mr. Howard Brown, who is the banking commissioner from Hartford, CT; Mr. Lewis who has just been introduced; and Mr. Kenneth Littlefield, who is the banking commissioner from Austin, TX.

I think what we'll do, gentlemen, is just go right down the table and make your full statements a part of the record. I think, to the extent that each of you can, we'd like you to summarize a few high points so that we can keep our time for an exchange afterward.

Mr. Gilleran.

STATEMENT OF JAMES E. GILLERAN, SUPERINTENDENT OF BANKS, SAN FRANCISCO, CA

Mr. **GILLERAN**. Mr. Riegle, Members of the Committee, it's a pleasure to be here.

I was appointed superintendent of banks on July 5, 1989. Prior to that time I was president of a small investment banking firm in San Francisco and prior to that I was managing partner of Peat-Marwick in San Francisco. During a 30-year career there, I spent a great deal of my time with the banking industry. It's a pleasure to be with you.

California is currently served by 436 banks, of which 270 are State. And the State assets are approximately $97 billion out of a total of $314 billion.

A significant reflection of California's bank performance is that no State-chartered bank and only one small national bank has failed since 1987.

There are many reasons for California's success in avoiding the banking problems encountered in other States and the strength and diversity of our economy contributes substantially to that success. Downturns in any one sector of our economy tend not to affect the overall health of California banks as in States where the economy is dependent on a few industries.

In the aggregate California State-chartered banks have an equity-capital ratio of 6.7 percent, while nationwide the ratio for all banks is 6.4 percent. There are only 20 banks with an equity-capital ratio of less than 5.5 percent and no bank has a ratio less than 2.4 percent. There are no insolvent State-chartered banks in operation.

Overall, the situation appears satisfactory and I'm satisfied that most banks under my supervision have adequate capital to protect the public interest and avoid any further crisis to the insurance fund.

The overall earnings of State-chartered banks continues healthy as evidenced by the excellent earnings in 1988 of $801 million and an even better performance for the first half of 1989. The annualized June 30, 1989 return on assets was 1.14 percent, which is a record; and the return on equity was 16.89 percent.

The earnings outlook should remain favorable barring major fluctuations in the economy. We have no reason for undue concern at this time in connection with the portfolio composition. The aggregate loan portfolio is 40 percent commercial, 36 percent real estate related, and 20 percent consumer loans. Only 2.7 percent of the total is to foreign entities.

Total nonperforming assets as of June 30, 1989 stood at $1.7 billion, down from $1.8 billion as of March 31 of this year. This represents 1.75 percent of State bank assets on June 30th. This compares very favorably to the all-California and the all-U.S. ratios which were 2.24 percent and 2.25 percent respectively.

Loan reserves were 2.16 percent, which is in line with all U.S. bank figures of 2.26 percent and we believe sufficient to cover future loan losses.

While any portfolio contains risks due to the economic cycle or other factors, we find no reason to conclude that the strong performance of the banks will not continue.

The California experience with expanded powers given State-chartered banks has been positive. The expanded authorities for California banks have been conservatively used and currently are successful. Most important of all, they are carefully supervised by our department.

Just to expand on that a little bit, since you're most interested in that area, in California the major expanded power of course is in the area of real estate investment and statutorially the State banking department was given the right to decide which of the State banks could engage in those activities.

So out of the 270 State banks in California, only 77 of them have been given the expanded real estate activities and only after we have carefully satisfied ourselves that, number one, the banks are successfully operating currently, that they are either CAML 1 or CAML 2; that they have the demonstrated expertise to make those kind of investments; and that they have the capital to do it. To date, of those 77 banks, even though the statute allows for them to invest up to 10 percent of their assets in such investments, to date in fact they have only invested less than 1 percent. In fact, it's .68 percent.

So that in total the expanded powers have been applied quite conservatively by the banks and are very well supervised. The types of projects in the main are single family dwellings and other residential type dwellings. Some of the major banks do have some projects of motels and shopping centers, but in the main they are single family dwellings.

The **Chairman**. Can I ask you a question? I won't want to interrupt too many times, but this is important.

You are familiar I'm sure with the savings and loan problems in California. Do you have the jurisdiction in that area?

Mr. **Gilleran**. No, I do not.

The **Chairman**. You do not. But you're certainly aware of the fact that real estate investment powers were a part of the problem in the S&L area.

Did you have any sense as to why that would have been so there, and not for banks now as you've seen them in California, as you've just described?

Mr. **Gilleran**. I believe the supervision was different. Whereas in the real estate area the powers are given across the board, in California, with the banks, they were not given across the board and it was up to the superintendent to decide which banks could do it after demonstrating the expertise. Frankly, I believe that that is the way that expanded powers should be put into operation.

The **Chairman**. Selectively and almost on a case-by-case basis?

Mr. **Gilleran**. Exactly.

The **Chairman**. Very interesting.

Mr. **Gilleran**. In the area of leveraged buyouts, the banking department conducted a study recently. We updated this for June 30th and found only our seven largest banks have any significant amounts of such credits. We note that such loans total approximately $1.8 billion. Only a small amount of the LBOs are reported to be on a non-performing basis.

Our figures indicate that loans to developing countries——

The **Chairman**. When you use the LBO category, would that include bridge loans—any kind of interim financing? I know some banks, for example, are involved in certain kinds of interim financing transactions and there's a question as to the degree of risk that may be associated with that versus a longer-term commitment. Maybe you could take a look at that and see if you can identify in the data that you have assembled on LBO how much of it would be of an interim type and how much of it a longer-term type and supply that for the record.

Mr. **Gilleran**. I will, sir.

We found that only our seven largest banks have any significant amount of those credits. We note that such loans total approximately $1.8 billion and only a small amount are non-performing.

Our figures indicate in the LDC area that accounts for $1.4 billion, which is 2.3 percent of the portfolio, and principally in loans to Latin America countries. Only a few large State-chartered banks are involved in foreign lending and these banks have over the past year and a half set aside adequate reserves for their LDC loans.

In response to your question regarding the timeliness and the effectiveness of our examination program, State-chartered banks are being examined and supervised in an effective and timely fashion. For the past few years we have operated under an informal arrangement with both the FDIC and the Federal Reserve Board to conduct alternate year examinations of non-problem banks. Other banks are examined by both the State and Federal agency in 1 year either separately or by use of a joint examination.

During 1988 over 91 percent of all State-chartered banks were examined by one of the regulatory agencies. By itself, the State banking department examined over 64 percent of its banks, including any problem banks and statutory year banks.

In 1989, despite a reduced presence of FDIC in California banks, our examination coverage will extend to all problem banks and to all statutory year banks.

The CHAIRMAN. May I just ask the question here—and I'll ask the others, too—do you have the resources within your State budget to be able to have sufficient personnel with the level of training and skill that you feel you need to do this job? Are you subjected to budget squeezes and problems that would cause you to have to spread yourself thin?

Mr. GILLERAN. We have the appropriate requests for all the budget that we think that we need to get our job done. We are meeting with our finance department on Thursday and I could probably tell you on Friday. But we feel that we will get the authority to get all the resources that we need. I believe this is viewed by the Governor as a very important area.

Out of our 270 State-chartered banks, 39 are operating under formal State or Federal regulatory orders. These orders are for many reasons, including our requests for additional capital to support growth and management or operating changes we believe are required.

All banks with outstanding regulatory orders are monitored on a periodic basis with monthly reports required from the banks. The California Banking Department monitors such banks whether the regulatory order is a State order or a Federal order.

In response to your request for a forecast of the industry's condition, we are optimistic and believe California banks will continue to remain profitable and in a satisfactory condition. As I noted in my opening remarks, the strength and diversity of California's economy contributes substantially to our banks' success in avoiding the problems faced by other States.

Finally, in order to deal with changes in the area we are responsible for supervising, the banking department in 1987 embarked on its first ever strategic plan. The plan is a long-range one. It emphasizes department efforts to actively manage change rather than reacting to it and also develops an ongoing process to monitor change.

We have recently completed the installation of an office automation system which links all four of our offices. We are now in the process of developing a comprehensive data base which will provide us with additional tools for our supervisory mission and have received approval this month to obtain laptop computers for use by our field examiners.

We have begun a conscious effort to meet more frequently with bank directorates either through board meetings at the conclusion of our examination or through outreach programs such as bank director forums.

In areas of enforcement, we proposed and were granted approval to create an investigative unit within the department.

In summary, I believe the California State Banking Department is well prepared and will continue to effectively supervise and regulate the banking and related industries under our jurisdiction in a manner that will promote public confidence in the health of the industry as well as provide the California economy with the benefits of a healthy financial services system.

Just to divert from my script in response to Mr. Wirth's question about the adequacy of bank capital and the question of 3 percent as suggested by the Comptroller or 6 percent, I believe a great deal of confusion exists in that regard in that the Comptroller of the Currency based upon the printed reports stated that the 3 percent is a bottom level leveraged ratio that he would use as an additional test to decide whether or not when risk-based capital measures are enforced that the risk-based capital does not result in a leveraged ratio of less than 3 percent.

When the risk-based levels were first devised, we did a survey in California and we matched the risk-based capital levels against the existing capital levels of California banks and we did not find that the risk-based formula would result in the great preponderance of our State banks—in fact, I believe all the community banks would meet the capital formula required by the risk-based level.

So I don't believe that the 3 percent would constitute any problem for us in California. My understanding of it is that it is just this bottom line test of the adequacy of the capital range.

[The complete prepared statement of James E. Gilleran follows:]

STATEMENT OF
JAMES E. GILLERAN
SUPERINTENDENT OF BANKS, STATE OF CALIFORNIA
Before the
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
OCTOBER 17, 1989

Chairman Riegle, Committee Members, my name is James Gilleran, Superintendent of Banks for the State of California. I am pleased to have the opportunity to appear before you today and report on the condition of state chartered banks in California.

California is currently served by 436 commercial banks, of which 270 are state chartered institutions under my supervision. Out of the approximately $314 billion in total banking assets, $97 billion is held by state chartered banks.

A significant reflection of California's bank performance is that no state chartered bank and only one small national bank has failed since 1987.

There are many reasons for California's success in avoiding the banking problems encountered in other states, and the strength and diversity of our economy contributes substantially to that success. Downturns in any one sector of our economy tend not to affect the overall health of California banks as in states where the economies are dependent on fewer industries.

In the aggregate, California state chartered banks have an equity capital ratio of 6.7% while nationwide, the ratio for all banks is 6.4%. There are only 20 banks with an equity capital ratio of less than 5.5%, and no bank has a ratio less than 2.4%. There are no insolvent state banks in operation. Overall, the situation appears satisfactory and I am satisfied that most banks under my supervision have adequate capital to protect the public interest and avoid any further crisis to the insurance fund.

The overall earnings of state banks continues healthy as evidenced by excellent 1988 earnings of $801 million, and an even better performance for the first half of 1989. The annualized June 30, 1989 Return on Assets was 1.14% and the Return on Equity was 16.89%. The earnings outlook should remain favorable barring major fluctuations in the economy.

We have no reason for undue concern at this time in connection with the portfolio composition. The aggregate loan portfolio is 40% commercial, 36% real estate related and 20% consumer loans. Only 2.7% of the total is to foreign entities.

Total non-performing assets as of June 30, 1989 stood at $1.7

billion, down from $1.8 billion as of March 31, 1989. This represented 1.75% of state bank assets on June 30th. This compares favorably to the all-California and all-U.S. ratios which were 2.24% and 2.25% respectively.

Loan reserves were 2.16%, which is in line with the all-U.S. banks figure of 2.26%, and we believe sufficient to cover future loan losses.

While any portfolio contains risk due to the economic cycle and other factors, we find no reason to conclude that the strong performance of the banks will not continue.

The California experience with expanded powers given state chartered banks has been positive. The expanded authorities for California banks have been conservatively used, are currently successful, and most important of all are carefully supervised.

In the area of Leveraged Buyouts (LBOs), the Banking Department conducted a study recently updated through June 30, 1989, and found only our seven largest banks had any significant amount of such credits. We note that such loans totaled approximately $1.8 billion. Only a small amount of the LBOs are reported to be on a non-performing basis.

Our figures indicate that Loans to Developing Countries (LDCs) account for a combined $1.4 billion, of 2.3% of the aggregate loan portfolio, principally in loans to Latin American countries. Only a few large state chartered banks are involved in foreign lending, and these banks have, over the past year and a half, set aside adequate reserves for their LDC loans.

In response to your question regarding the timeliness and effectiveness of our examination program, state chartered banks are being examined and supervised in an effective and timely fashion.

For the past few years, we have operated under an informal arrangement with both the FDIC and FRB to conduct alternate year examinations of non-problem banks. Other banks are examined by both the state and federal agency in one year, either separately or by use of a joint examination. During 1988, over 91% of all state chartered banks were examined by one of the regulatory agencies. By itself, the State Banking Department examined 64% of its banks, including all problem banks and statutory year banks.

In 1989, despite a reduced presence of the FDIC in California banks, our examination coverage will extend to all problem banks, and all statutory year banks.

Out of our 270 state chartered banks, 39 are operating under formal state or federal regulatory orders. These orders are for many reasons including our request for additional capital to support growth, and management or operating changes we believe are required.

All banks with outstanding regulatory orders are monitored on a periodic basis with monthly reports required from the banks. The California Banking Department monitors such banks whether the regulatory order is a state order or a federal order.

In response to your request for a forecast of the industry's condition, we are optimistic and believe California's banks will continue to remain profitable and in satisfactory condition. As I noted in my opening remarks, the strength and diversity of California's economy contributes substantially to our banks' success in avoiding the banking problems faced by other states.

Finally, in order to deal with changes in the areas we are responsible for supervising, the Banking Department in 1987 embarked on its first ever strategic plan. The plan is a long range one, emphasizes department efforts to actively manage change rather than reacting to it, and also develops an ongoing process to monitor change.

We have recently completed the installation of an office automation system which links all four of our offices. We are now in the process of developing a comprehensive data base which will provide us with additional tools for our supervisory mission, and have received approval to obtain Laptop Computers for use by our field examination staff.

We have begun a conscious effort to meet more frequently with bank directorates, either through board meetings at the conclusion of an examination, or through outreach programs such as bank director forums.

In the areas of enforcement, we proposed and were granted approval to create an investigative unit within the department.

In summary, I believe the California State Banking Department is well prepared, and will continue to effectively supervise and regulate the banking and related industries under our jurisdiction in a manner that will promote public confidence in the health of the industry as well as provide the California economy with the benefits of a healthy financial services system.

Thank you for giving me this opportunity to discuss the California banking climate, and to express my viewpoints.

STATEMENT OF
JAMES E. GILLERAN
SUPERINTENDENT OF BANKS, STATE OF CALIFORNIA
Before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
OCTOBER 17, 1989

Chairman Riegle, Committee Members, my name is James Gilleran, Superintendent of Banks for the State of California. Governor George Deukmejian appointed me to this position on July 5, 1989. I am a Certified Public Accountant by profession and as a partner for Peat, Marwick, Mitchell & Co., organized and managed their West Coast Banking Division in Los Angeles from 1964 to 1977. Subsequently, I was the managing partner of the San Francisco office of PMM & Co. until my retirement in 1987.

I am pleased to have the opportunity to appear before you today and report on the condition of state chartered banks in California.

Before responding to the questions asked in your letter of September 11, 1989, I would like to briefly give an overall view of the California banking industry. The statistical information I mention is included as attachments in tabular or graphic form.

California is currently served by 436 commercial banks, of which 270 are state chartered institutions under my supervision. Out of the approximately $314 billion in total banking assets, $97 billion is held by state chartered banks. Please refer to Tables I and II. California also permits statewide branching, and as of June 30, 1989, these 436 banks operated in excess of 4100 branch offices within the state. Savings and Loan Associations and Savings Banks are under the jurisdiction of the Savings and Loan Commissioner in this state and I will not comment on their performance.

California is also the domicile for 113 foreign banks that maintain agency or branch offices. Except for 11 federal branch offices, the remaining 102, with assets of approximately $74 billion, are entirely under my supervision

Additionally, the State Banking Department also supervises Trust Companies, Business & Industrial Development Corporations, Issuers of Travelers Checks and Money Orders, and Transmitters of Money Abroad.

A significant reflection of California's bank performance is that no state chartered bank and only 1 small national bank has failed since 1987. California had experienced 7 bank failures each of the previous 3 years, and 35 in all since 1982 (23 state chartered and 12 national). The 35 failures represents only 3.6% of the 970 failures experienced nationally during the same period (Table III), and in the aggregate represents less than 1/2 of 1% of total bank deposits in the state.

There are many reasons for California's success in avoiding the banking problems encountered in other states, and the strength and diversity of our economy contributes substantially to that success. Downturns in any one sector of our economy tend not to affect the overall health of California banks as in states where the economies are dependent on fewer industries.

Other factors such as the reliability of financial information reported to the department, earnings, examinations and enforcement will be addressed in response to the questions your letter directed at me.

Your first question concerns the adequacy of capital at banks under my supervision, and whether it is adequate to avoid a future crisis to the insurance fund.

In the aggregate, California state chartered banks have an equity capital ratio of 6.7% while nationwide, the ratio for all banks is 6.4%. In analyzing the individual equity capital ratios of our state chartered banks, we note that the mean equity capital ratio of these banks is 9.28%, and the median ratio is 8.44%. There are no insolvent state chartered banks in operation. Overall, the situation appears satisfactory and I am satisfied that most banks under my supervision have adequate capital to protect the public interest and avoid any further crisis to the insurance fund.

Currently both FDIC and OCC regulations require banks to maintain a 5.5% primary capital level and a 6% total capital level (total capital includes notes and debentures). Computing the total capital ratios for the 270 state chartered banks as of June 30, 1989, we find that only 10 banks, or 3.7%, failed to meet the required 6% level. Please see Table IV. (Tables IV through VI present the capital levels by size of bank).

When we compute the primary capital ratio (generally, equity capital and loan loss reserves) to total assets, we again find that the same 10 banks had a ratio of less than 5.5%. Please see Table V.

It is possible to establish even a stronger standard than the federal primary capital standard by using a ratio consisting only of equity capital (and not including loan loss reserves). Using such a calculation we find that only 20 banks (7.4%) had a ratio of less than 5.5% (none less than 2.4%.). Please see Table VI.

In summary, there are 10 banks that fail to meet the primary capital ratio of 5.5%, and the total capital ratio of 6%. All of these banks are under written regulatory agreements or cease and desist orders calling for an increase in capital, and those banks are being monitored either through visitations, telephone calls, or written monthly reports by the bank to our offices.

Additionally, we assign CAMEL ratings as do the federal bank regulatory agencies at the conclusion of each examination. The meaning of CAMEL and the rating factors are identical to those of the federal agencies (CAPITAL, ASSETS, MANAGEMENT, EARNINGS, and LIQUIDITY, rating of 1 or 2 considered satisfactory, 3 - less than satisfactory, and 4 and 5 considered unsatisfactory.)

When we examine the CAPITAL component of the CAMEL rating, per our most recent examination statistics, we find that 20 banks are rated a 4 or 5 while another 36 are rated a 3.

Finally, California law defines an impairment of capital as occurring when undivided profits reaches a deficit equal to 40% of capital funds. We currently have 5 such banks, and the shareholders of these banks have been ordered, pursuant to authority granted the Superintendent under the California Financial Code, to cure the impairment by an infusion of additional capital funds.

In response to question 2, I am pleased to report that the overall earnings of California banks continues healthy as evidenced by an excellent 1988 performance and an even better performance for the first half of 1989. The earnings outlook should remain favorable barring major fluctuations in the economy.

State chartered banks had aggregate 1988 earnings of $801 million, and continue to show excellent earnings of $550 million for the first six months of 1989 (see Table VII). Table VIII demonstrates that the annualized June 30, 1989 Return on Assets (ROA) of 1.14%, and Return on Equity (ROE) of 16.89% for these banks have been steadily increasing. Furthermore, only 12 or 4.4% of the banks experienced a loss, and four of these are new banks that normally lose money for the first three years. Unprofitable banks (Table IX) are down from a high of 87 banks in 1983.

The trend to profitability has generally increased since 1983 with the exception of 1987. We consider 1987 an aberration in that even though banks performed better than in previous years, extraordinary loan loss provisions that many larger banks took against loans to developing countries (LDC) distorted the aggregate picture. As Table X shows, California state banks have reserved 2.16% of their loans, which is in line with the all U.S. bank figure of 2.26%. Considering the low level of foreign loans, which we will discuss later, reserves appear sufficient to cover future loan losses.

It is our opinion that the earnings reported at California institutions accurately reflect their performance. Under Section 118 of the California Financial Code, banks are required to submit their reports to us under generally accepted accounting principles (GAAP). Additionally, we estimate that over 90% of the state chartered banks (including all the large and medium sized banks) have had CPA's audit their statements annually and certify them.

Normally, we do detect a few reporting errors made on the year end Report of Condition and Report of Income submitted by banks. This occurs primarily in the areas of loan loss reserves and accruals for taxes, and is largely due to the time constraints placed on banks by having to submit their called reports of condition and income statement within 30 days of year end. Such errors are rectified later when auditors review the year end financial statements. We do not believe there is any intentional misrepresentation by the banks and we are quite confident as to the general accuracy of bank reports. We have the ability to deal with erroneous or delinquent reports through civil penalties.

Question 3 deals with portfolio composition and I am pleased to report to you that we have no reason for undue concern at this time. As to the loan portfolio, in the aggregate, 40% of the loans are commercial and industrial, 36% of the loans are real estate related, 20% of the loans are consumer loans, and nearly 4% are other miscellaneous categories. Only 2.7% of the total is to foreign entities, and is reflected in the miscellaneous category noted above.

While any portfolio contains risk due to the economic cycle and other factors, we find no reason to conclude that the strong performance of the banks will not continue.

Table XI presents a comparison of the loan portfolio mix over the past 5 years, and shows a gradual percentage increase in real estate loans from 30.1% in 1983, to 35.6% as of June 30, 1989.

The expanded investment powers granted to thrifts has been the subject of much recent testimony, and many are of the opinion that the problems of that industry were largely caused by the increased powers. The California experience with expanded powers given state chartered banks has been different. We are pleased to report to you that the expanded authorities for California banks have been conservatively used, are currently successful, and most important of all are carefully supervised.

Over the past few years California banks have received authority to sell insurance, invest in equity securities, and invest in real estate. The most notable of these expanded powers is in the area of real estate investment and development. In 1984, California banks were authorized to invest in, develop, own, and sell such real property. The authority was limited by the Legislature to 10% of the assets of the bank when the activity is conducted through a subsidiary, and limited to the capital of the bank when undertaken directly.

In contrast to our understanding of the expanded powers granted to savings and loan associations, banks wishing to utilize the real estate investment powers must first obtain the approval of the Banking Department. Approval is granted only to satisfactorily performing banks, and only after the bank demonstrates the financial and managerial capacity to carry out the activity. The Banking Department has designed an examination program to monitor these activities, and has requested each bank's board of directors to adopt a conflict of interest policy concerning the bank's real estate activities.

Our records show that only 77 of our 270 banks are engaged in property development activity and these banks have, in the aggregate, invested only

$268 million (or less than 1% of their aggregate assets) in the activity. These investments are usually made in conjunction with customers the bank has had a long standing lending relationship with, and we find much of the activity involves residential construction. No bank has become a problem bank due solely to engaging in this activity, and our experience to date has shown that most banks have used the new power successfully, and in a productive and conservative manner. Table XII gives a recap of the activities in the area of real estate investment since 1985.

We might also mention, that in November 1988, the California electorate passed an initiative permitting banks to sell insurance products. Our department has worked with the Department of Insurance in exchanging information, and we have set forth a reporting requirement for banks intending to engage in the activity. We see no demonstrated need for any federal intervention or restriction on this lawful activity of California banks.

In the area of Leveraged Buyouts (LBO's), the Banking Department conducted an informal study last year, recently updated through June 30, 1989, and found only our seven largest banks had any significant amount of such credits. Our updated study shows that such loans totaled $1.8 billion and comprised 3.5% of the assets at those banks, nearly 13% of their commercial loan portfolios, and 5% of their total loan portfolio.

Approximately $70 million of the $1.8 billion, or 3.9%, of the LBOs are reported to be on non-accrual or restructured. Overall, of the $150-$160 billion in LBOs outstanding at all commercial banks, we estimate that less than 2% of that amount is held by our state chartered banks. Although we share the concern expressed by some about the potential risk in this type of lending activity, we do not see any present urgent danger with California state banks engaging in limited LBO lending.

As far as LDC's are concerned, our figures indicate that California state chartered banks hold a combined $1.4 billion in foreign loans, or 2.3 % of the aggregate loan portfolio, principally in loans to Latin American countries. Only a few multi-billion dollar state chartered banks are involved in foreign lending, and these banks have, over the past year and a half, set aside substantial reserves for their LDC loans. No further problems or additional negative impact on earnings at these banks due to their foreign loan portfolio is anticipated.

In response to your question regarding the timeliness and effectiveness of our examination program we are pleased to report that state chartered banks are being examined and supervised in an effective and timely fashion.

Table XIII gives details on the number of bank examinations conducted since 1983.

Our Department goal is to examine each bank at least annually, and certain banks on an even more frequent basis even though state law only requires examinations at least once every two calendar years. The department has succeeded in reducing the period between examinations over the past few years, in part due to an innovative examination program called FOCUS, and extended only to CAMEL 1 and 2 banks that meet criteria pertaining to their internal reports, controls and stability of management.

The program has been successful in it's objectives of a more frequent, efficient examination of banks, and of increasing the level of communication between the department and the banks we supervise. Examiner hours conserved on examining these better run banks is now being utilized more effectively in examining our problem banks. Only 2 of the approximately 90 FOCUS banks have been dropped from the program due to deficiencies discovered at a subsequent regular examination.

This FOCUS program, with minor modifications, has essentially remained the same since its inception in 1985, and the examination is performed partially at the bank using bank management reports, and partially in our offices using computer generated reports and analyses.

Additionally, for the past several years, we have operated under an informal arrangement with both the FDIC and FRB to conduct alternate year examinations of non-problem banks. In addition, some banks are examined by both the state and federal agency in one year, either separately or by use of a joint examination. During 1988, over 91% of all state chartered banks were examined by one of the regulatory agencies. By itself, the State Banking Department examined over 64% of its banks, including all problem banks and statutory year banks.

In 1989, despite a reduced presence of the FDIC in California banks, our examination coverage will extend to all problem banks, and to all statutory year banks.

The Banking Department has also strengthened its off-site analytical capabilities, through the creation of a Financial Analysis Unit. This unit utilizes personal computers to monitor banks and analyze trends in individual banks as well as the industry.

We are also pleased to report that the number of banks considered "problem" (CAMEL 4 and 5) has declined substantially over the last few years. The Department gives special monitoring attention to these banks, and is in frequent contact with the banks' management. For example, each of these banks is subject to either a state or federal written agreement or memorandum of understanding requiring correction of the unsatisfactory condition. These banks now total 24, or less than 9% of our banks. Table XIV presents a history of these banks since 1983.

In response to question 5 concerning our record with regard to initiating, and accomplishing goals for enforcement actions, we report as follows.

Out of our 270 state chartered banks, 39, or 14.4%, are operating under issued and outstanding formal state or federal regulatory orders. These actions include six capital impairment orders, six state issued cease and desist orders, ten federal cease and desist orders, 6 state regulatory agreements, 21 Federal memorandums of understanding, one order to terminate insurance and one other miscellaneous order.

All banks with outstanding regulatory orders are monitored on a periodic basis with monthly reports usually required from the banks. The California Banking Department monitors such banks whether the regulatory order is a state order or a federal order.

In response to your request for a forecast of the industry's condition, we are optimistic and believe California's banks will continue to remain profitable and in satisfactory condition. As I noted in my opening remarks, the strength and diversity of California's economy contributes substantially to our banks' success in avoiding the banking problems faced by other states.

From an analysis of the earnings of the banks during the first six months of 1989, we note that earnings come primarily from continuing operations, and only 3.7% of the income came from extraordinary items. Overhead expenses have been kept in control over the past few years, and loan losses have declined.

Also showing improvement is the volume of delinquent loans at state chartered banks. Delinquencies as of June 30, 1989 were $2.8 billion, down from the March 31, 1989 figure of $3.2 billion. The percentage of delinquent loans dropped to 4.71% as of June 30, 1989, down from 5.34% on March 31, 1989. At the 1982 high point for State banks 9.99% of all loans were delinquent. Table XV presents an overview of delinquent loans since 1982, and as previously noted Table X presents the reserve for loan losses compared to total loans.

We have previously noted the absence of recent bank failures, and the reduction in the number of problem banks.

Banks in California appear to perform well in a moderately rising interest rate environment. We anticipate that the interest rate environment for the next few quarters will remain stable, and will be one which will allow banks to maintain their healthy progress. Although the LDC debt crisis has serious implications for those banks with a substantial exposure in that area, we believe that state-chartered banks with LDC outstandings have previously set aside sufficient reserves to cover future losses.

One factor that we are aware of is the growing percentage of real estate loans in bank portfolios. Several banks, especially in southern California, have extended a substantial amount of real estate credit. Although the California real estate market is exceptionally strong, any significant downturn could affect California banks.

Your final question concerns actions the Banking Department might take to remedy perceived deficiencies or capitalize on new opportunities. We will of course be cognizant of both. The banking industry continues to operate in a complex and ever changing environment. Banking and bank regulators face challenges on several fronts and will have to deal with new situations created by FIRREA, with the new risk based capital guidelines, and with impending interstate banking, etc.

In order to deal with these and other changes in the areas we are responsible for supervising, the Banking Department in 1987 embarked on it's first ever strategic plan. The plan is a long range one, emphasizes department efforts to actively manage change rather than reacting to it, and also develops an ongoing process to monitor change. As a part of the plan, several task forces were created to study and submit proposals on various aspects of our operation, including developing new application and examination procedures, reporting and training.

We have recently completed the installation of an office automation system which links all four of our offices. We are now in the process of developing a comprehensive data base which will provide us with additional tools for our supervisory mission.

Also we have requested approval from our State's Administration to procure Laptop Computers for use by our field examination staff. This is seen as a necessary step to expand our analytical capabilities. Training, a high departmental priority, has been increased significantly over the past two years with the appointment of a full time professional training officer, and a substantial increase in the training budget.

We have begun a conscious effort to meet more frequently with bank directorates, either through board meetings at the conclusion of an examination, or through outreach programs such as bank director forums. We believe an important key in good banking practice starts with educating the bank's board as to acceptable banking practices.

In the areas of enforcement, we proposed and were granted approval to create an investigative unit within the department. The investigators will have limited peace officer status, and will provide support to our examination staff when irregularities or criminal activities are discovered. They will also be used to evaluate and screen applicants for new charters, and will work with prosecutorial agencies in preparing cases against white collar criminals.

Other departmental efforts to keep abreast of changing times include a preliminary study of the reasons for the bank failures we have experienced in California. Admittedly, the study is preliminary and will require further detailed analysis. However, we have begun to build on the preliminary results, and an article reviewing the major factors of failure has been coauthored by one of my Deputies and myself for dissemination to our examination staff. A copy of the article and of the preliminary study is appended to this testimony for your information.

The Banking Department has also begun a project to re-evaluate how we rate the management of each bank. The project, similar in concept to the new standards recently published by the Comptroller of the Currency, has been assigned to an Assistant Deputy and has a high priority.

The State Administration is also exploring the consolidation of various departments which oversee financial institutions such as the Banking Department, the Department of Savings and Loan, the Financial Services Division of the Department of Corporations and Mortgage Bankers and Brokers now regulated by the Department of Real Estate. Such a consolidation is in response to the blending of financial services institutions, and it would provide for better cross training, cross fertilization of ideas and a consistent application of regulatory standards. We believe a consolidated department would bring about better communication between state regulators and their federal counterparts, while at the same time helping preserve the dual chartering system.

In summary, I believe the California State Banking Department is well prepared, and will continue to effectively supervise and regulate the banking and related industries under our jurisdiction in a manner that will promote public confidence in the health of the industry as well as provide the California economy with the benefits of a healthy financial services system.

Before I conclude my testimony there are a few comments I would like to offer for your consideration. We in the state regulatory system ask that careful attention be paid to protect the integrity and viability of the dual banking system which has in the past and can continue to serve our nation well. Some have suggested that Congress curtail state authority in supervising the banks we charter. Moreover, they have suggested that expanded powers in the areas of real estate, insurance and securities are the source of todays problems. These powers are exercised conservatively by banks in California and the facts do not support such a claim.

We have been extremely frustrated with the actions of the Federal Reserve Board in attempting to unilaterally nullify state granted powers exercised in state chartered bank subsidiaries of a bank holding company or the subsidiaries of these state chartered banks. As an example, in many cases California bank holding companies applying to acquire an additional bank have been forced to agree to divest real estate investment activities conducted in the state chartered bank or in the bank's subsidiary. Additionally, the Federal Reserve Board continues to propose regulations affecting the ability of state chartered banks to lawfully exercise state granted powers. As such, the Federal Reserve Board's actions are a direct confrontation to the dual banking system. Congress did not intend to give this authority to the Federal Reserve Board in the Bank Holding Company Act. Federal oversight has been successfully conducted by the FDIC and coordinated with state banking departments. We have consistently filed comments with the Board opposing wholesale elimination of new bank powers, based upon the success of the real estate investment activity we have previously mentioned.

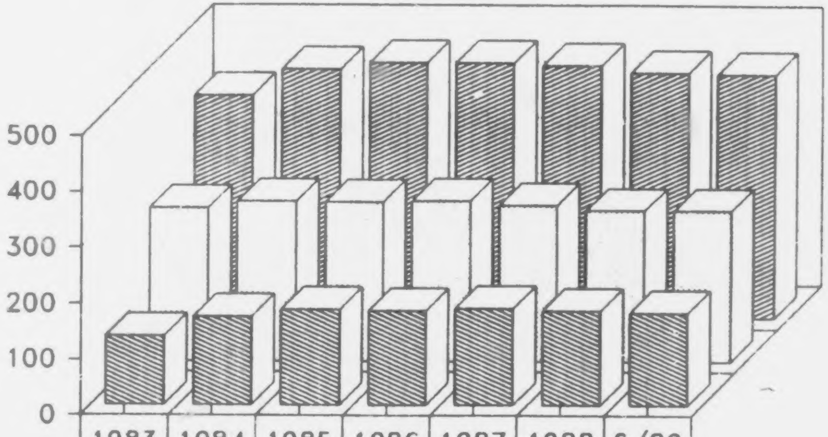
Our dual banking system has its roots in the separation of the state and federal governments of this country. This system is designed to provide a banking system that is tailored to the needs and local economic conditions of each state. Attempts to lay the savings and loan crisis entirely on the backs of the states, and thereby strip the states of their long founded authority would be inappropriate, and would eliminate the ability to initiate innovative approaches to banking problems and issues.

Thank you for giving me this opportunity to discuss the California banking climate, and to express my viewpoints.

TABLE I

CALIFORNIA BANKING

NUMBER OF BANKS

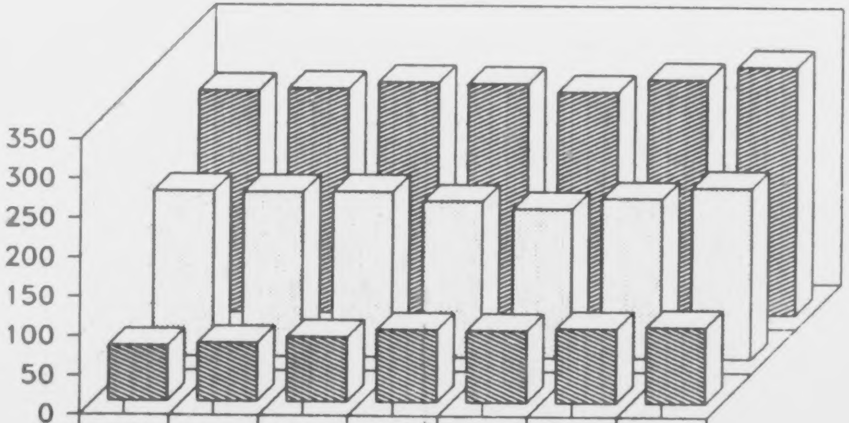


	1983	1984	1985	1986	1987	1988	6/89
TOTAL # OF BANKS ▨	397	444	456	456	452	439	436
# OF STATE BANKS ☐	274	286	285	287	279	270	270
# OF NAT'L BANKS ▧	123	158	171	169	173	169	166

TABLE II

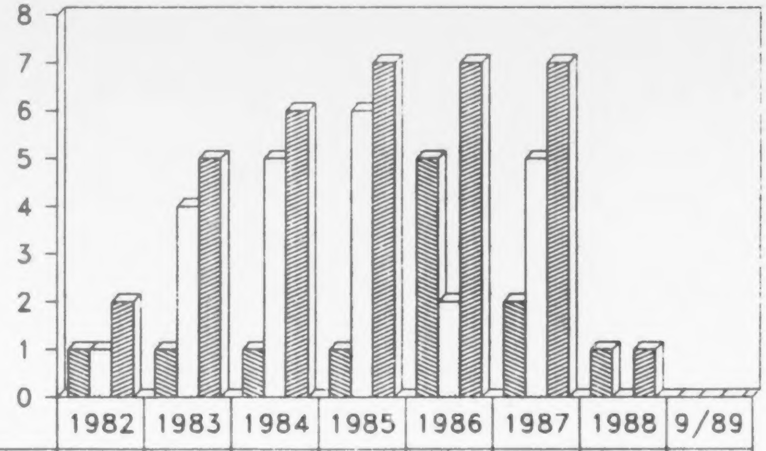
CALIFORNIA BANKING

ASSETS IN $ BILLIONS



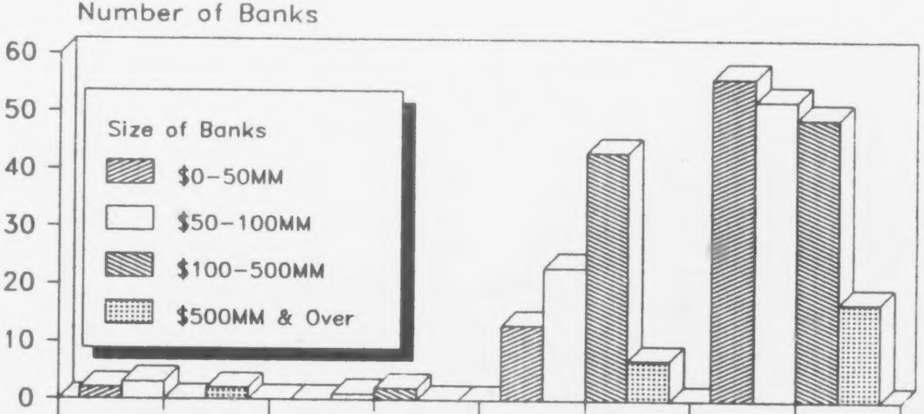
		1983	1984	1985	1986	1987	1988	6/89
TOTAL ASSETS	▨	280.9	283.4	292.4	290.5	280.4	297.1	313.7
NAT'L BK ASSETS	☐	210	209.1	210	198.1	189	202.7	217
STATE BK ASSETS	▨	70.9	74.3	82.4	92.4	91.4	94.4	96.7

TABLE III
CALIFORNIA BANK FAILURES
SINCE 1982



		1982	1983	1984	1985	1986	1987	1988	9/89
CA NAT'L BANKS	▨	1	1	1	1	5	2	1	0
CA STATE BANKS	☐	1	4	5	6	2	5	0	0
TOTAL CA BANKS	▨	2	5	6	7	7	7	1	0
TOTAL UNITED STATES		42	48	79	120	138	184	200	159

TABLE IV
SHAREHOLDERS' EQUITY, RESERVES & NOTES/TOTAL ASSETS
(A Breakdown by Bank Asset Size)

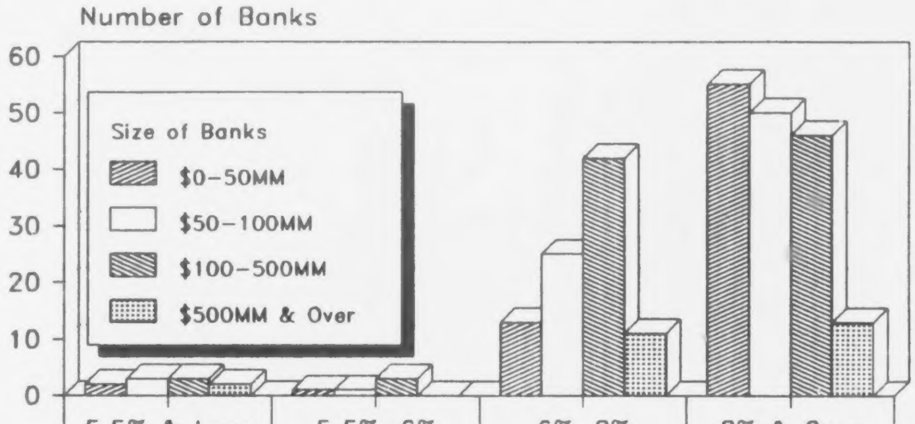


	5.5% & Less	5.5%-6%	6%-8%	8% & Over
$0-50MM	2	0	13	56
$50-100MM	3	1	23	52
$100-500MM	0	2	43	49
$500MM & Over	2	0	7	17

TABLE V

SHAREHOLDERS' EQUITY & RESERVES/TOTAL ASSETS

(A Breakdown by Bank Asset Size)

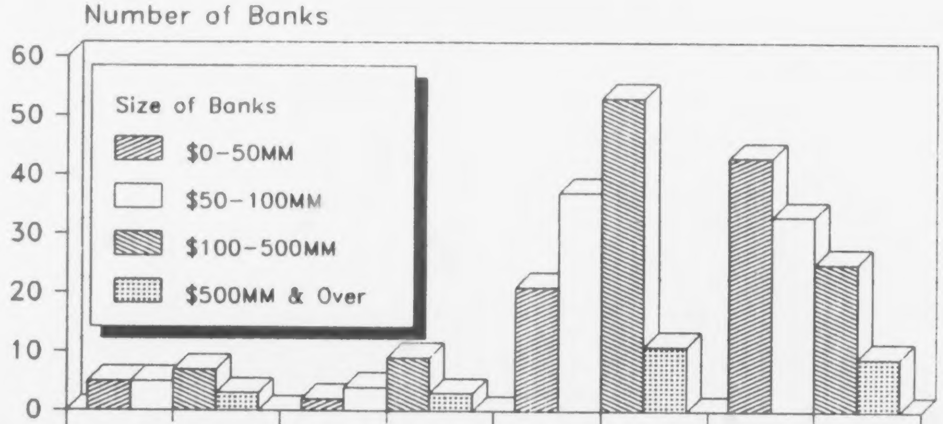


	5.5% & Less	5.5%-6%	6%-8%	8% & Over
$0-50MM	2	1	13	55
$50-100MM	3	1	25	50
$100-500MM	3	3	42	46
$500MM & Over	2	0	11	13

TABLE VI

SHAREHOLDER'S EQUITY/TOTAL ASSETS

(A BREAKDOWN BY BANK ASSET SIZE)

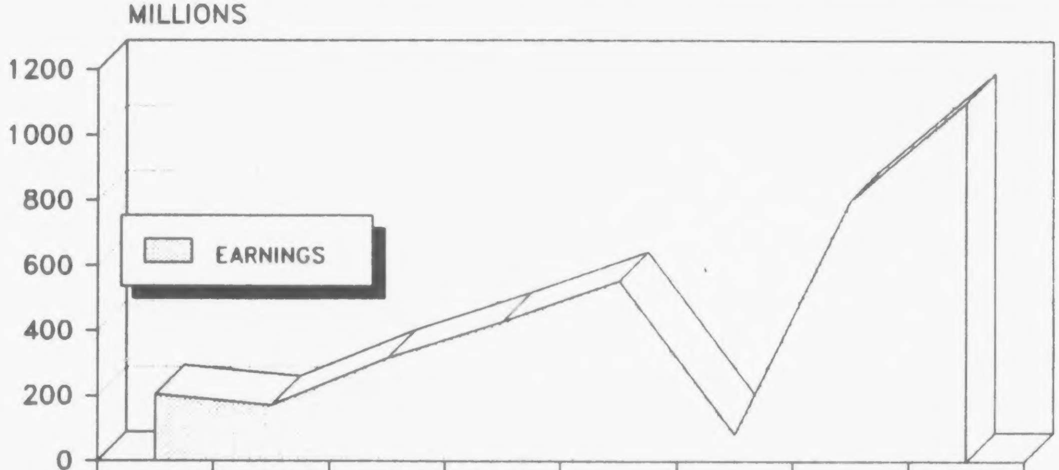


	5.5% & Less	5.5%-6%	6%-8%	8% & Over
$0-50MM	5	2	21	43
$50-100MM	5	4	37	33
$100-500MM	7	9	53	25
$500MM & Over	3	3	11	9

TABLE VII

AGGREGATE EARNINGS

(California State Chartered Banks)



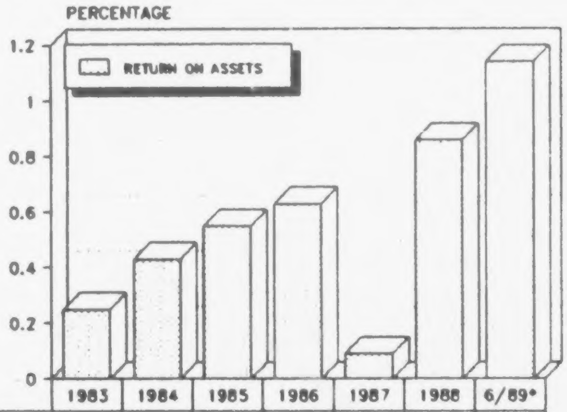
	1982	1983	1984	1985	1986	1987*	1988	6/89**
EARNINGS	205.1	171.3	315.6	428.7	552.2	83.1	801	1101.6

*Aggregate provision for loan losses totaled $1,245MM in 1987.

**1989 earnings projected for full year.

TABLE VIII

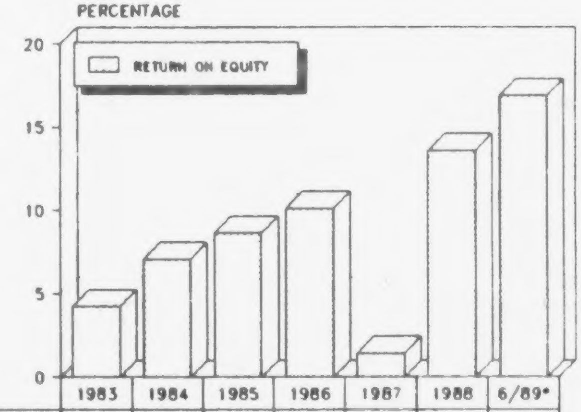
RETURN ON ASSETS
(California State Chartered Banks)



	1983	1984	1985	1986	1987	1988	6/89*
RETURN ON ASSETS	0.25	0.43	0.55	0.63	0.09	0.86	1.14

*ANNUALIZED

RETURN ON EQUITY
(California State Chartered Banks)



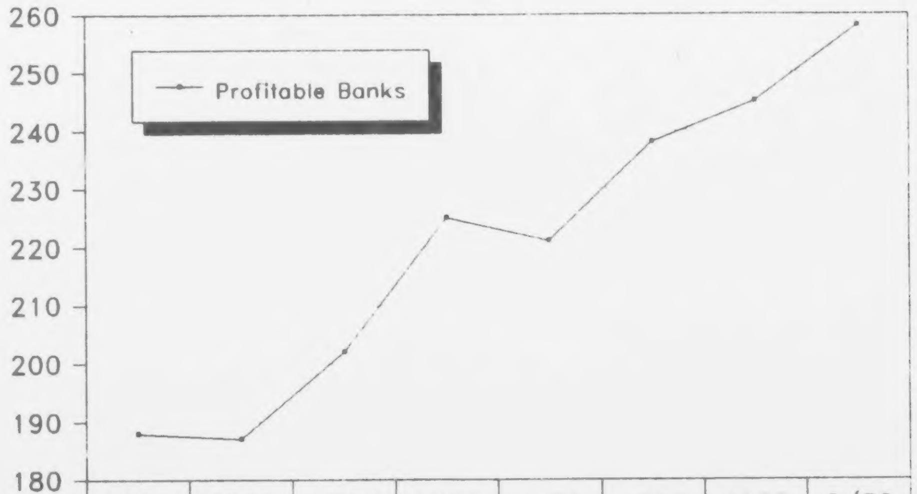
	1983	1984	1985	1986	1987	1988	6/89*
RETURN ON EQUITY	4.25	7.08	8.65	10.13	1.45	13.6	16.89

*ANNUALIZED

TABLE IX

NUMBER OF PROFITABLE BANKS

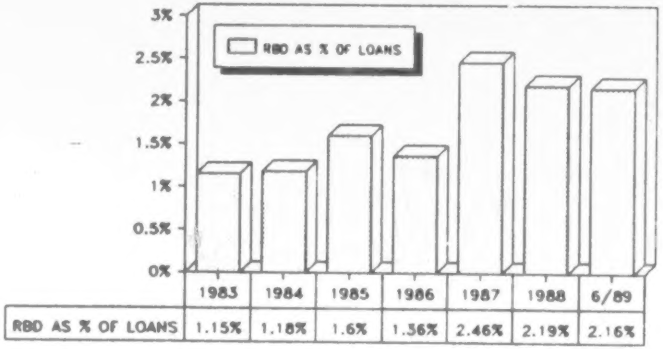
(California State Chartered)



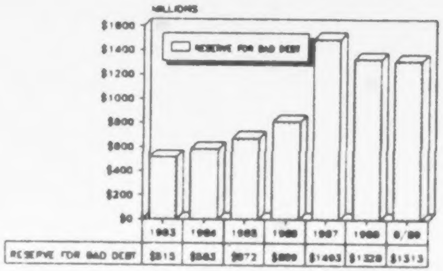
	1982	1983	1984	1985	1986	1987	1988	6/89
Profitable Banks	188	187	202	225	221	238	245	258
Unprofitable Banks	76	87	84	60	66	41	25	12
Total # of Banks	264	274	286	285	287	279	270	270

TABLE X

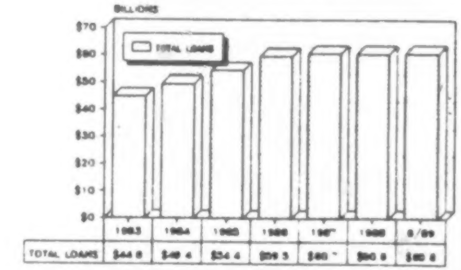
RESERVE FOR BAD DEBT AS A % OF TOTAL LOANS
(California State Banks)



RESERVE FOR BAD DEBT
(California State Banks)



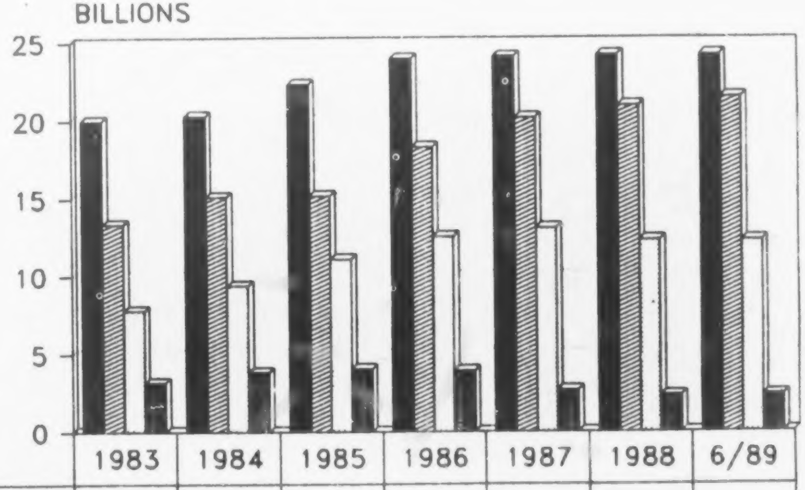
TOTAL LOANS*
(California State Banks)



* Includes Leases

TABLE XI

COMPOSITION OF LOAN PORTFOLIO
(California State Chartered)



		1983	1984	1985	1986	1987	1988	6/89
COMMERCIAL LOANS	■	19.98	20.29	22.32	23.97	24.1	24.22	24.23
REAL ESTATE LOANS	▨	13.33	15.1	15.15	18.29	20.17	20.94	21.5
CONSUMER LOANS	□	7.77	9.38	11.08	12.54	13.08	12.29	12.29
OTHER LOANS	▩	3.17	3.83	4.05	3.92	2.67	2.34	2.38

TABLE XII

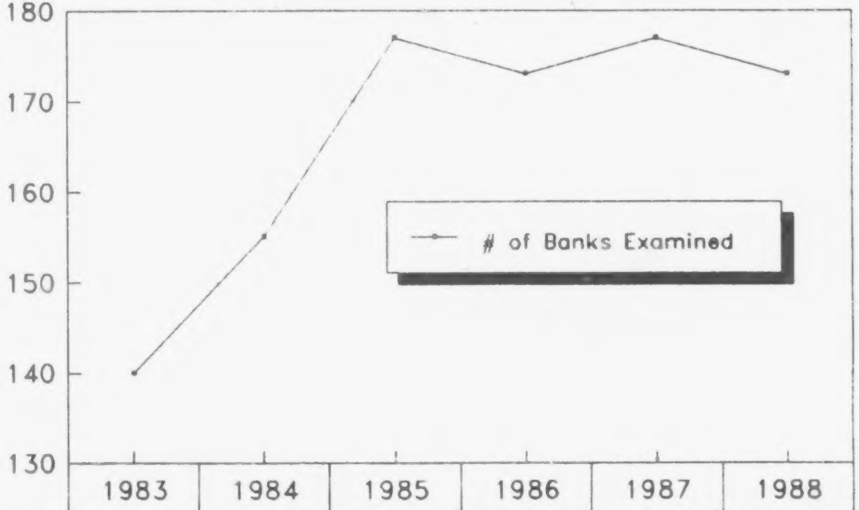
REAL ESTATE INVESTMENTS MADE UNDER SECTION 751.3
(IN MILLIONS)

DATE	ALL STATE BANKS		BANKS UTILIZING REAL ESTATE POWERS			% OF ASSETS INVESTED
	#BANKS	$ASSETS	#BANKS	$ASSETS	$INVESTED	
06-30-85	287	77,606	47	n/a	49.7	n/a
12-31-86	287	92,402	63	10,000	99.9	.99
09-30-87	280	90,044	69	n/a	127.5	n/a
12-31-87	279	91,243	69	n/a	167.0	n/a
06-30-88	276	93,957	70	24,618	207.3	.84
09-30-88	272	93,552	73	26,265	214.5	.82
12-31-88	270	94,494	75	36,669	243.5	.66
03-31-89	270	94,247	76	37,395	247.2	.66
6-30-89	270	96,700	77	42,665	268.4	.63

TABLE XIII

NUMBER OF BANKS EXAMINED

(California State Chartered)

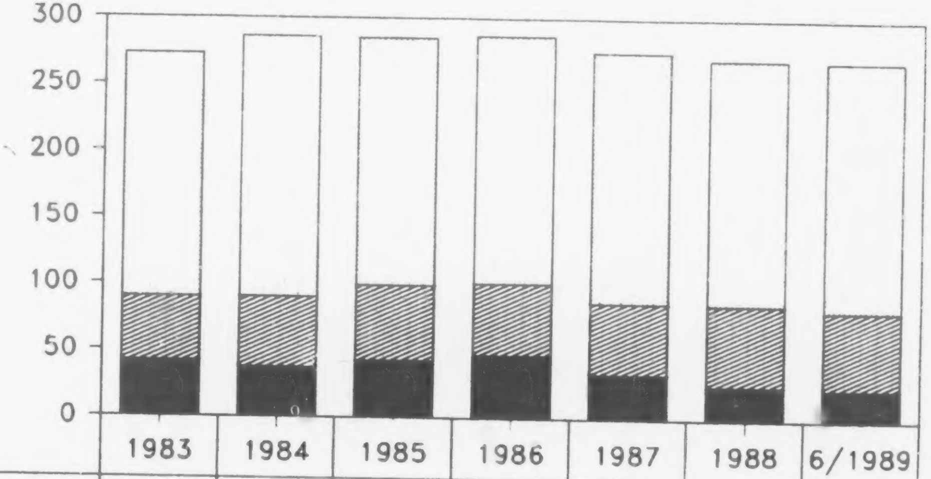


	1983	1984	1985	1986	1987	1988
# of Banks Examined	140	155	177	173	177	173
% of Total Banks	51.1	54.2	62.1	60.3	63.4	64.1

TABLE XIV

CAMEL RATINGS

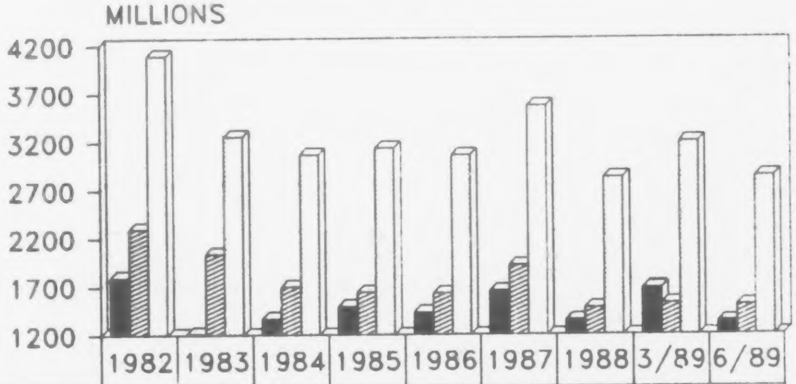
(State Chartered)



	1983	1984	1985	1986	1987	1988	6/1989
CAMEL 1 & 2 ☐	183	196	186	186	188	184	187
CAMEL 3 ▨	48	53	56	54	53	60	58
CAMEL 4 & 5 ■	42	37	43	47	34	26	24

TABLE XV

DELINQUENT LOANS
(California State Chartered)



		1982	1983	1984	1985	1986	1987	1988	3/89	6/89
30–89 Days Past Due	■	1797	1214	1369	1493	1435	1653	1348	1677	1335
90 Days Past Due	▨	2299	2040	1697	1640	1626	1916	1477	1523	1502
Total Loans Past Due	□	4096	3254	3066	3133	3061	3569	2825	3200	2837
90 Day as % of Loans		5.51	4.61	3.49	3.11	2.77	3.19	2.47	2.54	2.49
Past Due % of Loans		9.99	7.41	6.31	5.96	5.21	5.95	4.72	5.34	4.71

REVIEWING EXAMINATION TECHNIQUES

James E. Gilleran, California Superintendent of Banks and John Paulus, Deputy Superintendent of Banks

Just when you thought it was safe to relax!! Earnings are up, loan delinquencies down, problem banks at a manageable level, and no California state-chartered bank failures for nearly two years.

Why worry then? Well, for one thing, no one has yet repealed the business cycle. What goes up can come down, frequently with a thud!! A good economy with resultant high earnings can obscure a multitude of bad practices, but when the cycle turns down there's no hiding the flaws in your system!

Many businessmen tend to let their guard down when times are good and there appears to be no crisis worth worrying about. The difficult lessons both bankers and regulators learned during the past few years of economic uncertainty and multiple bank failures must not be allowed to be forgotten, and must be carefully preserved in our training and in our examination techniques.

Therefore, we have begun a process of looking at the different reasons several of our licensees got into serious trouble. That, despite the generally close analysis and follow up our staff exercises in the case of all banks, and especially at those banks where a problem had been detected. We plan to re-evaluate all of our field and office techniques for monitoring licensees, and to give refresher training to staff members as needed.

Over the years, there have been several scholarly studies of bank failures. The Federal Deposit Insurance Corporation (FDIC) has produced several papers on failures and, most recently, the Office of the Comptroller of the Currency (OCC) published a study of the causes of recent national bank failures.

We believe that by identifying major problem indicators, it might be possible to direct examination resources and techniques to look for similar indicators in future examinations. Our study was not intended to be exhaustive, but only a preliminary indicator of what areas to concentrate our resources on. A bank autopsy, while interesting, can be of major importance if the lessons learned are passed on to our examination staff.

Twenty three state-chartered banks failed during the period 1982-1987. While no state banks have failed since 1987, there are still several with severe problems that must be continually monitored. Of the 23 failures, we found the principal factor to be poor loan quality and a concentration of credit to a single or related borrower(s). The following table lists both a primary and secondary reason for failure that was identified by our examiners and supervisory staff.

CALIFORNIA STATE CHARTERED BANK FAILURES 1982 - 1987

	PRIMARY	%	SECONDARY	%
Loan Quality/Concentration	11	47.8	12	52.2
Insider Abuse	5	21.7	1	4.3
Internal Fraud	2	8.7	1	4.3
External Fraud	1	4.3	1	4.3
Operational Losses	1	4.3	14	60.9
Excessive Bank Premises	1	4.3	3	13.0
Economy of the Area	2	8.7	1	4.3
Ineffective Board/Management			10	43.5
	23	100.0	43	

TRAINING YOUR STAFF

Ironically, one of the most important traits of a good examiner is one that can't be taught. Over the years we've known many examiners and auditors, and the most successful ones tend to be those that have an inquisitive mind set. It seems they have an ability to look at a loan or other account and focus on characteristics that may not be quite as apparent to another (the i's may be dotted and the t's crossed, but maybe they're just a little out of sync).

Fortunately however, there are other important warning indicators (red flags) that can and should be taught. Equally as important, once one of these flags is waved, examiners must be schooled to follow through until they have a full explanation of what the true situation is.

Many of the red flags track the causes listed in the table on failures presented earlier. Loans are the principal asset of a bank, and when there are loan problems you will ultimately have a bank problem if they are large enough. These indicators in a loan portfolio vary widely, but some of the more frequent are: poor procedures for analysis, review, approval and documentation, high rates that indicate high risk, out-of-area loans, high delinquencies, frequent extensions or renewals, lack of collection effort, and low or non-existent loan reserves.

Concentrations to a single borrower, or to multiple borrowers deriving their livelihood from the same industry also should be an indication of potential trouble. In one industry communities, a strike or recession can lead to the failure of the unfortunate bank having its loan portfolio primarily loaned out to employees of that industry.

As you will also note from the chart, operational factors contribute heavily to the closing of banks. Such factors include management, earnings and liquidity problems. Examples include sloppy operations and housekeeping, management turnover, lack of audits, high overhead due to excessive fixed assets or salaries, volatile deposits and use of brokered funds, and engaging in unfamiliar activities without proper management controls.

TRAINING YOUR STAFF (continued)

Our analysis also indicated that ineffective management was present as a secondary factor in 43.5% of the failures. Many would disagree and would advance the argument that poor management was, in the final analysis, responsible for all the failures.

Additionally, one of the most important types of training you can give to an examiner is in how a bank becomes profitable. An examiner armed with a grasp of a successful bank's operations is in a much better position to evaluate the bank currently under examination. Most of the better training courses now include a computer simulation for managing a bank. The student controls various factors such as the loan mix, funding sources, maturity spreads, interest rates paid and charged, and competes with classmates over a period of time to see who runs the more successful bank. It gives each student experience with the ripple effect one marketing or investment decision can have on a balance sheet or income statement.

Training has been given a high priority in the Banking Department. We now have a full time professional training officer, and a training budget of $100,000. We focus on the areas of technical training necessary for bank supervision including expanded banking powers, deregulation, and emerging products and technologies; legal training; and management and supervisory development.

EXAMINATIONS

There are, of course, many different steps to an examination, and in fact there are even a variety of different examinations, each employing a different scope. The State Banking Department uses a work program that sets forth three basic types, with the possibility for further tailoring each type to the specific institution under examination. Type I is a full scope or "traditional" examination. Type II is our "focus" examination, reserved for CAMEL 1 and 2 banks having good management reporting systems, an operating budget, and stable management. Focus examinations utilize an alternative methodology where one or upon the management reports of the bank itself. Type III is basically a credit examination, but one that also looks at other pertinent areas of the bank.

Despite the varied scopes of examination, we expect our examiners to provide Banking Department management with an overall analysis of each bank. Therefore, we must look at and evaluate all of the risks in each bank, and determine how they have been accounted for. All of our examinations are structured to look at the CAMEL of each bank (an acronym most of you are familiar with derived from Capital, Assets, Management, Earnings, and Liquidity). Each factor is rated separately from 1 (best) to 5 (worst), with a composite rating also assigned. CAMEL 1 and 2 banks are considered satisfactory, a CAMEL 3 is a marginal bank, and a 4 or 5 bank is considered a problem.

REVIEW OF TECHNIQUES

There are a variety of tests or techniques an examiner can employ in an examination. Depending upon the confidence the examiner has in the accuracy of the records of the bank under examination, certain techniques may not be applied.

However, regardless of the scope of the examination or (in some cases) the problem free status of the bank, there are certain evaluations that should always be made.

The following paragraphs list those areas which we believe to be of sufficient importance to test at each examination. Other techniques may also be used at the discretion of the examiner, but those listed here form the basis for assuring coverage of all areas that might lead to future problems.

Overall Analysis

** Every examination should constitute an overall analysis of the five CAMEL factors as well as other major areas (e.g. operations, marketing, new banking powers used, etc.) that go into an evaluation of Management.

In addition to the field examination, our Department prepares periodic financial analyses of our banks using quarterly Report of Condition and Report of Income data to compute trends and comparative analyses.

Naturally, the overall analysis is not complete until the finalized Report of Examination is given to Department management to decide whether any enforcement action is necessary.

** The greatest areas of risk should always be looked at, and would include the following:

° PAST DUE LOANS - as noted earlier, loans represent the major share of a bank's assets, and loans that become uncollectable will ultimately result in a charge to earnings, whether directly or through a reserve. Loans must be properly reviewed, documented, approved, and reported to higher authority where necessary. Banks must have the necessary systems to detect delinquencies and immediately begin collection procedures. Banks must have a comprehensive loan policy, including procedures for charge-offs, and reporting to management.

° CONSTRUCTION LOANS - under California banking law a bank may commit up to 25% of it's shareholders equity, allowance for loan losses, and capital notes and debentures on a construction loan. The term of the loan may be for 60 months, and the amount of advance may not exceed 85% of the property and improvements. Such loans may be for a variety of purposes, either commercial or residential, but all carry more than average risk. There are usually time frames to contend with, contractors and sub-contractors to evaluate, and disbursements to be made only after specified goals have been accomplished. In case of a default, the bank may be forced to complete the project to make it saleable.

REVIEW OF TECHNIQUES (continued)

Overall Analysis (continued)

- CONCENTRATION OF CREDIT - in our examination procedures, anything over 25% of shareholders equity represents a concentration of credit. Loans to the same or related borrowers in excess of this limit constitute a violation of the principle requiring diversification of risk. In certain other circumstances, loans to unrelated borrowers that look to the same source of repayment, or to a single industry for their wages (such as the fishing industry or lumber industry) could similarly be viewed as a concentration of risk.

- PROFITABILITY - we all know that it is important to make a profit in order to stay in business. However, the true test is whether the profits are sustainable. Did the bank show a profit by selling off fixed assets? Or, by taking profits out of the securities account? Are earnings and expense accruals accurate, and does the loan loss reserve appear to be adequate. There are many ways to show a temporary profit, and the examiner must evaluate the continuing earnings potential of the bank.

- TREND ANALYSIS - an examination is a snapshot of a bank at one particular date. We can analyze the CAMEL of the bank, compute ratios and write a report giving our opinion of the bank as of the examination date. However, knowing what a bank's earnings or capital ratio is as of one date really doesn't give the full picture. You have to know what the ratio was one month ago, one year ago, etc. in order to judge the direction the bank is heading. Is the ratio increasing or decreasing, are earnings going up or going down. Without a trend analysis no Report of Examination can be complete.

- LIQUIDITY - now includes different types of asset & liquidity management, the matching of maturities and interest rates. One primary concern is the ability to convert an asset into cash without significant loss within a reasonably short period of time. Other concerns include the degree a bank has funded long term assets with short term liabilities, and the impact an upward shift of interest rates would have if the liabilities were to be repriced and the assets could not be.

- CHANGES IN OPERATIONS - are there any new programs being operated such as leasing operations, insurance sales, securities sales, real estate development, investments in equity securities, new subsidiaries, etc. If there are changes, what were the steps the bank took to prepare itself to engage in the program? Did they obtain expert consultants, hire experienced staff, develop a business plan, secure the approval of the Board of Directors, notify the regulator if required? In short, have they looked before they leaped?

REVIEW OF TECHNIQUES (continued)

Overall Analysis (continued)

° CHANGES IN OWNERSHIP OR BOARD - may indicate new directions and programs for the bank. Goals, authorities, reporting structures may have changed, and should be reviewed to make sure they have not been weakened. New policies may have been set, and new personnel may be in key positions. As noted above, new programs instituted by new management must be reviewed.

Note should be taken of any significant sale of shares pending, or of any sale of convertible notes.

° EXPERIENCE OF OFFICERS - our procedures call for an evaluation of all officers that have a significant impact of the forming or application of bank policy. The officer's prior experience and training are important factors in our evaluation, as is the quality of the work he or she is currently doing. Officer or managerial strength is a vital consideration in how we rate the management factor in a bank.

° POSSIBILITY OF MANAGEMENT OVERRIDE - is reviewed by observation, have controls been ignored, have lending or reporting limits been continually observed in the breach? The policies set forth by the Board of Directors are only good if they are observed. Exception reports should track violations, and a senior officer or auditor should review them. On the other hand, continued violation may indicate a need to review the policy to determine it's continued validity.

Loan Portfolio Review

** The collectability or saleability of the loan portfolio is the primary determinant as to whether a bank lives or dies. The policy of this Department is to review a sufficient portion of the loans to adequately determine the overall quality of the entire portfolio. General guidelines have been set depending upon the CAMEL rating of the bank, for example, our policy is to look at 50% of the dollar value of commercial and construction loans in a CAMEL 1 or 2 bank, 60% at a CAMEL 3 bank, 70% at a CAMEL 4, and at the Deputy's discretion, higher at a CAMEL 5.

Real estate loans are looked at only if severely delinquent, or if large in size. Installment loans are generally classified on a formula basis, those loans 90/120 delinquent are substandard, and those over 120 days are classified loss.

There are other considerations such as collateral, documentation such as pledges, financial statements, analyses, and, in this day, consumer disclosure documents. Many of these items are tested when the file is worked evaluating the credit, but in other instances, random checks are made. Certain of the considerations we believe important are as follows:

REVIEW OF TECHNIQUES (continued)

Loan Portfolio Review (continued)

° WHO IS RESPONSIBLE - it is important that each credit have an individual assigned to it. Responsibility resides not only for the original granting of the credit, but for subsequent follow up, and collection efforts if needed. Loan committees generally review credits over a certain size for compliance with bank policy and to critique the credit, but collective responsibility is a concept that does not work.

° SECURED LOANS - can lull you to sleep. There is a danger in relying upon collateral instead of the character and creditworthiness of a proven borrower. Collateral must be perfected properly, can depreciate, can be inadvertently released, and in some cases has proven to be counterfeit. Even under the best of circumstances, the bank may still have problems in selling the collateral for a sufficient amount to retire the debt.

° SAFETY OF LARGE NUMBERS - can be a positive factor in your appraisal of a portfolio. Without even considering an analysis of individual credits, significant differences may exist between a portfolio of commercial loans and one of consumer loans. For example, two banks, both having loan portfolios of $100,000,000 can have widely divergent risks should bank A have a portfolio of 100 loans each of $1,000,000, while bank B has a portfolio of 100,000 loans each of $1,000. For each bank to lose half its portfolio, bank A needs only to have 50 loans go bad, while bank B would have to have 50,000 loans go bad.

° SEGREGATED SAMPLES - is the typical method we employ to review the appropriate volume of credit in the portfolio. Large loans are marked for review, as are delinquent loans, matured loans, loans showing frequent renewals, and credit lines that show continuously in debt. Other loans with known relationships such as guarantees, related borrowers, partners, control shareholders of corporations, etc. would also be marked for review. Loans of insiders are also reviewed.

° RANDOM SAMPLES - also have value in a test of the portfolio, whether for creditworthiness or for file documentation and proper approvals. While not a major tool, we still do occasionally send verification letters to a small sample of accounts.

Bank Operations

** The physical plant, systems, funding and operations of the bank contain many areas where problems can arise that might cause serious long term consequences. Some of the more important items are the following:

REVIEW OF TECHNIQUES (continued)

Bank Operations (continued)

° USE OF BROKERED DEPOSITS - should be carefully reviewed. Brokered deposits are not intrinsically evil, however, they may be extremely expensive and they are most definitely volatile funds. Brokered funds become dangerous when they are used to fund long term loans. The brokered funds typically mature in 3 to 6 months and will move rapidly to another institution paying a higher rate, leaving the first institution with a liquidity problem.

° INVESTMENT IN BANK PREMISES - normally represents a banks largest capital expenditure, and usually its largest non-earning asset. As indicated in our earlier table, the costs associated with excessive bank premises have actually caused or contributed to failures. The examiner must analyze the banks occupancy expenses and determine whether they are within acceptable limits.

Additions or deletions from the premises account should be carefully reviewed, as should be depreciation methods. The bank should have a comprehensive plan of insurance coverage which should be reviewed annually by the Board of Directors for adequacy.

Any bank premises that is not owned should also be carefully reviewed. Leases should be read, and terms of payment checked to the banks expense records.

° SECURITIES PORTFOLIO - types and maturities. At year end 1988, on an aggregate basis, securities represented over 13% of state bank assets, the second largest area of earnings assets after loans. Securities are needed to pledge against public deposits in some cases, provide income, and if marketable provide the bank with a ready source of liquidity.

Banks should adopt an investment policy that outlines the mix of securities to be held, the maturities, and the domicile of the portfolio. Securities dealers should be carefully chosen and approved by the Board of Directors as part of the investment policy. Investment limits must be set for persons authorized to purchase the securities, and credit files maintained for issues of limited marketability.

Invoices should be reviewed, and accounting entries verified. Periodic appraisals of the portfolio should be made by the bank, and presented to management.

° REVIEW OF CAPITAL - including the type and structure of the capital funds, whether these accounts include capitalized intangibles such as goodwill, the adequacy of capital taking into account current operations, earnings, dividend payouts, asset quality, growth trends, and future plans for expansion or new products. Examiners should also review any plan the bank has to maintain or increase its level of capital.

REVIEW OF TECHNIQUES (continued)

Bank Operations (continued)

- INTERNAL AUDIT REPORTS - should always be reviewed. Much can be learned of the operations and condition of the bank from these reports. All departments should be audited on a reasonable periodic schedule, and a formal reporting structure should be in place. The internal auditor should report to the Audit Committee of the Board of Directors, and should not report to any operating officer of the bank except for administrative purposes. Audit reports call for a formal response indicating corrective action taken.

- EXTERNAL AUDIT REPORTS - are another valuable tool that should be reviewed. The audited statements with footnotes provide an excellent resource to the examiners in evaluating the overall condition of the bank, including off balance sheet contingencies. The management letter prepared by the external auditor should be reviewed to alert the examiner to operational problems, and the examiner should follow up to determine whether any exceptions have been corrected.

- CONSUMER COMPLIANCE - reports of the federal agencies may indicate whether the bank is vulnerable to criminal action or class action suits for violations of law or regulation. Consumer tests in our examination work program are also to be completed.

  Prior to starting the examination, the examiner reviews the office correspondence and complaint files to determine whether any pattern of bank action warrants further scrutiny during the examination.

  During the examination, examiners frequently pull a file or two at random to test compliance with consumer laws. There is benefit in reviewing even a small sample, sometimes referred to as "the test of one".

Reporting Results

** A Report of Examination is always prepared on as timely a basis as is possible; corrective actions may need to be taken, or an enforcement order based upon the Report may be in order. The Report, property of the State Banking Department, is a report from the examiner to the Superintendent of Banks and the bank is furnished a copy for their internal use only. A response is requested from the bank detailing what actions they have taken to correct criticisms contained in the report.

REVIEW OF TECHNIQUES (continued)

Reporting Results (continued)

- ° FOCUS ON IMPORTANT ISSUES - Page 1 of the Report of Examination contains the examiners comments. The impact of your report can be diluted greatly if minor or extraneous issues clutter page 1. Issues of secondary importance should appear on the operations page or other subsidiary schedules.

- ° MEET WITH BOARD OF DIRECTORS - For many years the Department did not consider it necessary to meet with Boards of Directors unless there were severe problems with a bank. Reports of Examination were sent to banks which required directors to certify to us that they had reviewed the report and understood the condition of the bank.

  The risk inherent in not meeting with the Board, was that frequently incumbent management of the bank would be free to explain the Report of Examination to them, leaving the potential for glossing over management inadequacies.

  As a part of the Focus examination program, a policy of meeting with the Board after the conclusion of such examinations was initiated. It has proven extremely valuable to meet with the Board to explain first hand our evaluation of their bank, and any criticisms we might have. The Board also has expressed satisfaction with the ability to meet the regulator face to face and ask questions about their bank, or banking in general.

Conclusion

** The past few difficult years have caused many of the regulatory agencies to re-evaluate the methods and techniques used in traditional bank examination. Many of the techniques established over the years still have merit. However, we also found that as financial powers and products change, we need new training and new techniques.

The personal computer has become increasingly invaluable for monitoring trends, calculating ratios, and comparing banks with their peers. Portable computers are now available that can be taken into the field and can be used on-site to test and compare up to the minute figures. Software can be purchased to analyze a banks securities portfolio, asset and liability management policies, loans and loss reserves.

In the final analysis, the regulator must constantly keep up with the industry and possibly, with good planning, precede it. The techniques you use dictate the product you produce. Those with a good Examination Report product will be in a position to prevent future debacles.

FAILURES OF CALIFORNIA STATE BANKS IN THE 1980's

A REVIEW AND ANALYSIS

by P.K. PRAKASH

The findings of a preliminary study of the failed California state chartered banks are detailed in this analysis. This initial analysis was done mainly to detail the structural and operating characteristics of the failed banks. The next phase of this study is to develop a system of indicators that would serve as "early warning signals" and would help the department in identifying potential problems before they actually occur thereby increasing regulatory oversight on our part for those banks. This we believe would limit healthy banks from becoming problem banks. One of the main purposes of this brief analysis of failed banks was to isolate some of the differences between healthy and problem banks. Some of the potential advantages of an early warning system that we hope to develop are as follows.

1. More effective use of the pre entry/pre examination functions.
2. Optimum use and allocation of resources.
3. Can be used as a training tool for examiners.
4. Will add to overall effectiveness of supervision.

As an initial step, I looked at the detailed reasons for bank failures of state chartered banks in the 1980s. From May, 1976 to April, 1982 no state chartered bank failed. In 1982, 1 state chartered bank failed and 1 national bank failed as well. The table below gives a detailed breakdown of the number of bank failures in California as well as nationally since the beginning of 1980.

BANK FAILURES

YEAR	CA STATE CHARTERED	CA NATIONAL	ALL CA	ALL U.S
1980	-	-	-	10
1981	-	-	-	10
1982	1	1	2	42
1983	4	1	5	48
1984	5	1	6	79
1985	6	2	7	120
1986	2	5	7	138
1987	5	2	7	184
1988	0	1	1	200
	23	12	35	831

As the chart above shows, 23 state chartered and 12 nationally chartered banks have failed in California in the 1980's. This works out to 4.2% of the 831 banks that have failed in the U.S. Since the beginning of this decade. The percentage for California state chartered banks alone works out to 2.8%.

Structural characteristics of the failed California state chartered banks are given below:

ASSET SIZE	NO. OF BANKS	% OF TOTAL FAILED BANKS
Up to $25MM	11	48
$25MM to $50MM	6	26
$50MM to $100MM	3	13
$100MM to $300MM	3	13
TOTAL	23	100

NO. OF YEARS IN OPERATION	NO. OF BANKS	% OF TOTAL FAILED BANKS
Less than 3 years	1	4.3
Between 3 to 5 years	4	17.2
Between 5 to 10 years	10	43.5
Over 10 years	8	35.0
TOTAL	23	100.0

NO. OF OFFICES OF FAILED BANKS	NO. OF BANKS	% OF TOTAL FAILED BANKS
UNIT BANKS	10	43.5
1-3 OFFICES	10	43.5
3-5 OFFICES	2	8.7
OVER 5 OFFICES	1	4.3
TOTAL	23	100.0

As can be seen from the charts above, the banks that failed have generally been small, as evidenced by the fact that 87% of the banks were within $100MM in asset size. Not surprisingly, the charts reveal that over 78.5% of the banks were in existence over 5 years. Before we go into the actual causes for the bank failures, let us take a look at the median size of the failed banks and compare it to the median size of the state chartered banks for each of the years and see if the banks that failed were representative of the bank population.

YEAR	MEDIAN SIZE OF CA STATE CHARTERED FAILED BANKS (IN $MM)	MEDIAN SIZE OF CA STATE CHARTERED BANKS (IN $MM)
1982	9.0	47.0
1983	21.0	49.5
1984	40.0	52.0
1985	29.5	56.0
1986	55.0	68.9
1987	23.0	70.0

Below another table gives a comparative figure on the failure of California state chartered banks versus the overall figure of the failure of state chartered banks nationwide.

YEAR	NO. OF STATE CHARTERED BANKS THAT FAILED	%OF STATE CHARTERED BANKS THAT FAILED	NO. OF CA STATE FAILURES	%OF CA ST FAILURES
1982	31	.31	1	.37
1983	39	.40	4	1.46
1984	63	.66	5	1.75
1985	90	.95	6	2.10
1986	96	1.03	2	.70
1987	132	N/A	5	1.79

The above chart tends to indicate that in general a greater proportion of the California chartered banks failed as compared to the national average for state chartered banks.

During the same period that we are looking at 1982-1988, let us take a look at the number of 5 rated banks -- banks which were rated totally unsatisfactory.

YEAR	NO. OF 5 RATED BANKS INCLUDING FAILED BANKS	NO. OF STATE CHARTERED BANK FAILURES
1982	7	1
1983	14	4
1984	11	5
1985	16	6
1986	14	2
1987	13	5
1988	3	0

The above table reveals that roughly a third of the banks in the "5" category failed. In fact a look at all 5 rated banks since 1982 reveals that over 35% of the bank have shown a substantial improvement in performance be it due to increased regulation or better management/control. Roughly 30% of the banks have continued at a level which can be considered unsatisfactory even though some of the banks have shown a marginal improvement to be 4 rated banks.

Above were a few of the structural characteristics of failed banks. Now a look at the major causes of the failures. Several of these causes are, of course, interrelated and bank failures could be usually traced to a combination of these factors.

REASONS FOR FAILURE

	Primary	Secondary
Loan Quality/concentrations	11	12
Possible Insider Abuse	5	1
Ineffective Board/Management	-	10
Internal Fraud	2	1
External Fraud	1	1
Operational Losses	1	14
Excessive Bank Premises	1	3
Economy of Area	2	1
	23	43

It is seen from the above chart that the overwhelming factor in the failures has been the poor loan quality as evidenced by the fact that nearly 50% of the banks that failed had poor loan quality as the primary cause of failure and another 52% had loan quality as a secondary reason. A recent study by the OCC of 179 failed national banks came up with a similar conclusion. Economic problems played a major role in 35% of the failures of the national banks studied. In California given the generally robust and diversified nature of the economy even during the previous recession, the economic conditions played a major role in only 10% of the failures. Similarly, the OCC study found that insider abuse played a major role in 35% of the failures. California figures indicate that only 5 or 21.7% of the failures could insider abuse be attributed as a major cause of the failures. Also, the OCC study found that material fraud played a role in 11% of the causes. This factor could be considered a major factor in a similar % of the failures of state chartered banks as well even though in several ways, the failures in California differ from failures nationally though poor asset quality/loan is a major cause in failures at both the levels.

The analyses reveals that there are large identifiable statistical differences between the banks which failed and the healthy banks even two years prior to the failure of the banks. Statistical differences are apparent in the areas of capital ratios, loan volume, delinquency ratios, efficiency ratios. Thus, by pinpointing certain areas of bank operations, it may be possible to develop an early warning system which could alert us to any changes in the bank's financial condition caused by a change in the method of operations.

This initial study was done mainly to detail the structural characteristics and a few operating characteristics of the banks that have failed in California. The next phase is to begin developing an "early warning" system to identify future problem banks.

The following are some of the pertinent facts that emerged from the study.

(1) Capital ratios declined an alarming 3% on average in the last year of existence of the bank. Capital ratios stayed at the same level the year prior to closing as compared to two years prior to closing. This, in spite of the fact that in a number of cases more capital has been pumped in to the bank. Losses ate up almost all the new capital put in.

(2) Asset levels changed drastically in the last three years of existence. No discernible trend of either growth or decline was noted amongst the banks studied. What was consistent was that the banks' asset levels were not at steady levels and changed by as much as 60% in one instance in less than a year. This factor can be incorporated into our "early warning" system. Quarterly reports generated can easily alert us to changes in asset levels/loan levels over a desired stable level.

(3) Loan problems are the major cause of failures as is born out by the extremely high delinquency ratio -- over 14% of the loans are delinquent in each of the periods examined.

(4) As can be seen from the above factors, the banks cannot be expected to earn any money and none of the banks did. 90% of the banks that failed lost money for more than 2 years in a row.

(5) Overhead expense levels were consistently high in the last two years of existence-one plausible explanation for this is that the banks tried to hire senior management people at very high salaries to lure them to the banks. Also, legal and consulting expenses were very high at these banks.

The CHAIRMAN. Very good. That's very useful testimony and I appreciate the degree to which you've focused your responses to the issues that we are trying to examine.

Let me acknowledge the presence of the commissioner of financial institutions in my home state of Michigan, Mr. Gene Kuthy, who is here today and lending, I'm sure, moral support to his colleagues seated at the table. I'm delighted that he's joining us as well.

Mr. Brown, we would be pleased to hear from you now.

STATEMENT OF HOWARD B. BROWN, BANKING COMMISSIONER, STATE OF CONNECTICUT

Mr. BROWN. Thank you, Chairman Riegle.

Chairman Riegle, distinguished members of the Committee on Banking, Housing, and Urban Affairs, my name is Howard Brown. I am the banking commissioner of the State of Connecticut, first appointed in September of 1985. Prior to that I had been the deputy for three years.

It is with great pleasure that I address you today and I am particularly pleased to have been invited to testify on the condition of the banking industry in Connecticut.

In the essence of time, I've tailored my oral remarks to address three areas of specific concern. I did respond to all seven in my written comments which I made available to the committee.

Connecticut's banking industry is among the strongest in the country. My appearance before you today is perhaps a testament to that. In Connecticut the level of primary capital, which includes equity capital and the allowance for loan losses, is strong and improving.

As of June 30, 1989, Connecticut had 54 State-chartered commercial banks and 64 State-chartered savings banks, all of which were FDIC or BIF insured. These 118 institutions had aggregate assets and primary capital of $55.9 billion and $4.8 billion respectively.

The ratio of primary capital to total assets was 8.67 percent, up from 8.58 percent at year end of 1988. The 54 commercial banks have total assets of $16.8 billion and a primary capital ratio of 8.22 percent, compared to 7.91 percent as of December 31, 1988.

The 64 savings banks had aggregate assets of $39.1 billion and a primary capital ratio of 8.86 percent, nominally lower than the December 31, 1988 figure of 8.88 percent. In essence, they were virtually the same.

Every institution had a primary capital ratio in excess of 6 percent of total assets. Furthermore, Connecticut State-chartered banks have traditionally been involved in residential real estate lending. As of June 30, 1989, 20 percent of the total assets of commercial banks and 48 percent of the total assets of savings banks were invested in loans secured by one to four family residential properties. Since this type of loan will fall within the 50 percent category under risk-based capital guidelines, State-chartered institutions will also be highly capitalized under this method of calculation. The 54 commercial had aggregate return on assets of .95 percent for 1988, which was consistent with the levels of prior years going back to 1984.

Annualized earnings for the 64 savings banks were .79 percent through June 30, 1989, the same return on assets as was recorded for 1988.

Much media attention has been made of the recent downturn in earnings of institutions in the Northeast. However, at least for Connecticut State-chartered institutions the facts indicate that earnings depletion is not endemic to the entire industry. Exclusive of nine new banks that had been open for less than 2 years and had not yet attained profitability, only four of the State-chartered banks had deficit earnings through the first 6 months. The losses incurred by two of the four can be directly attributed to extraordinary charges made to the loan loss reserves in order to prudently provide additional funds to the loan loss reserve. Each of these four institutions has primary capital in excess of 7 percent.

In light of the fact that State-chartered banks have increased their loan evaluation reserves from $252 million or .60 percent of total loans as of year end 1988, to $325 million or .75 percent as of June 30, 1989, earnings are generally satisfactory.

The loan portfolio for the 118 State-chartered banks aggregates some $43.5 billion which represents 78 percent of total assets. Real estate loans total $32.9 billion and represent 76 percent of the entire loan portfolio. $22.3 billion of the total real estate loans, which account for 51 percent of total loans and 40 percent of total assets, are secured by one to four family residential properties.

The real estate loans secured by other than one to four family residential properties total $10.6 billion or 25 percent of the total loan portfolio.

Commercial and consumer loans account for the vast majority of the remainder of the portfolio. Commercial loans total $6 billion and represent 14 percent of the portfolio and installment aggregate some $4 billion, which is 9 percent of total loans.

Loans to finance leveraged buyouts and those extended to foreign borrowers account for a negligible portion of credit extensions.

As I mentioned previously, State-chartered banks maintain an allowance for loan losses totaling $325 million, which represents .75 percent of total loans. Net of residential real estate loans which are highly collateralized, the allowance would then be 1.53 percent of total loans. The allowance account also represents some 38 percent of total nonperforming loans. Since 66 percent of total nonperforming loans are secured by real estate, the existing loan loss reserve maintained by State-chartered banks is sufficient to fully cover 100 percent of our nonperforming unsecured loans as well as some 6 percent overlapping coverage for the nonperforming loans which are secured by real estate.

In the worst case scenario, if State-chartered banks have to charge off nonperforming assets, only six institutions would end up below 3 percent leveraged ratio recently proposed by the Comptroller of the Currency. Such a situation is highly improbable, particularly in light of portfolio distribution, the coverage afforded by the allowance for loan losses and the level of equity capital available.

In closing, I would like to emphasize that Connecticut's State-chartered banks are being examined and supervised in an effective and timely fashion. The capabilities of the Connecticut Department of Banking have been recognized nationally. Connecticut was one of the first States to be accredited for its performance by the Conference of State Bank Supervisors. The Department of Banking has developed an internal monitoring system based on the analysis of off-site data which facilitates the scheduling of examinations. Special attention is paid to institutions that have problems such as deteriorating asset quality, declining earnings, or capital dissipation.

In addition to the examination process, I personally maintain a close working relationship with the various State banking organizations and have an open door policy with all of the institutions under my supervision. The combination of effective and timely examinations and direct personal communication with banking organizations and bankers on an individual basis enhance the regulatory process.

Thank you very much.

[The complete prepared statement of Howard B. Brown follows:]

STATE OF CONNECTICUT
DEPARTMENT OF BANKING
44 CAPITOL AVENUE • HARTFORD, CT 06106

TESTIMONY OF
HOWARD B. BROWN
BANKING COMMISSIONER, STATE OF CONNECTICUT
BEFORE THE
U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
ON THE
CONDITION OF THE COMMERCIAL BANKING INDUSTRY

OCTOBER 17, 1989

An Equal Opportunity Employer

Mr. Chairman, and distinguished members of the Committee on Banking, Housing and Urban Affairs, my name is Howard Brown. I am Banking Commissioner of the State of Connecticut.

It is with great pleasure that I address you today and I am particularly pleased to have been invited to testify on the condition of the banking industry in Connecticut.

In the essence of time, I have tailored my oral remarks to address three of the seven specific concerns raised in the letter of invitation sent to me by Sen. Riegle. A more detailed response to all seven questions have been distributed for your review.

As Banking Commissioner, my responsibility is to protect the citizens of Connecticut by insuring the safety and soundness of our financial institutions. To uphold this charge means not only protecting the funds which consumers place in the hands of our banking institutions, but, of equal importance, protection of the very stability of the state's financial environment.

Connecticut's banking industry is among the strongest in the country. My appearance before you today is perhaps a testament to that. I'm confident this testimony, together with my written statement, will provide the necessary statistics to point out that Connecticut's banking industry is in good health.

The level of primary capital, which includes equity capital and the allowance for loan losses, is strong and improving. As of June 30, 1989, Connecticut had 54 state chartered commercial banks and 64 state chartered savings banks, all of which were FDIC (BIF) insured. These 118 institutions had aggregate assets and primary capital of $55.9 billion and $4.8 billion, respectively. The ratio of primary capital to total assets was 8.67%, up from 8.58% at Year End 1988. The 54 commercial banks had total assets of $16.8 billion and a primary capital ratio of 8.22%, compared to 7.91% as of December 31, 1988. The 64 savings banks had aggregate assets of $39.1 billion and a primary capital ratio of 8.86%, nominally lower than the December 31, 1988 level of 8.88%. Every institution had a primary capital ratio in excess of 6% of total assets.

Furthermore, Connecticut state chartered banks have traditionally been involved in residential real estate lending. As of June 30, 1989, 20% of the total assets of commercial banks and 48% of the total assets of savings banks were invested in loans secured by one to four-family residential properties. Since this type of loan will fall into the 50% category under risk based capital guidelines, state chartered institutions will also be highly capitalized under this method of calculation.

Earnings reported by state chartered banks continue to reflect the true results of operations. Reports are prepared according to generally accepted accounting principles and are in conformance with FDIC reporting procedures.

The 54 commercial banks had an aggregate return on assets of 0.95% for 1988, which was consistent with levels for prior years since 1984. The annualized return through June 30, 1989 declined to 0.47% principally because one institution expensed a significant special provision through its loan loss account in order to provide additional funds to its allowance for loan losses. Barring this special situation, the average annualized return on assets through the first six months would have been consistent with prior periods. Annualized earnings for the 64 savings banks were 0.79% through June 30, 1989, the same return on assets as was recorded for 1988.

Much media attention has been made of the recent downturn in earnings for institutions in the Northeast. However, at least for Connecticut state chartered institutions, the facts indicate that earnings depletion is not endemic to the entire industry. Exclusive of nine new banks that have been open for less than two years and have not yet attained profitability, only 4 of the state chartered banks had deficit earnings through the first six months. The losses incurred by two of the four can be directly attributed to extraordinary charges made to the loan loss reserve in order to prudently provide additional funds to the loan loss reserve. Each of these four institutions has primary capital in excess of 7%.

In light of the fact that state-chartered banks have increased their loan valuation reserves from $252 million or 0.60% of total loans as of year-end 1988 to $325 million or 0.75% as of June 30, 1989, earnings are generally satisfactory.

As to the loan portfolio composition of our 118 state-chartered banks, I have continually encouraged bank management to diversify their portfolios to prevent against unforeseen occurrences which could be catastrophic.

The loan portfolio for the 118 state chartered banks aggregates $43.5 billion which represents 78% of total assets. Real estate loans total $32.9 billion and represent 76% of the entire portfolio. $22.3 billion of total real estate loans, which account for 51% of total loans and 40% of total assets, are secured by 1-4 family residential properties. Commercial and consumer loans account for the vast majority of the remainder of the portfolio. Commercial loans total $6 billion and represent 14% of the portfolio and instalment loans aggregate $4 billion, which is 9% of total loans. Loans to finance leveraged buyouts and those extended to foreign borrowers account for a negligible portion of credit extensions.

As I mentioned previously, state chartered banks maintain an allowance for loan losses totaling $325 million, which represents 0.75% of total loans. Net of residential real estate loans, the allowance is 1.53% of total loans. The allowance account also represents 38% of total non-performing loans. Since 66% of total non-performing loans are secured by real estate, the existing loan loss reserve maintained by state chartered banks is sufficient to fully cover 100% of all non-performing unsecured loans as well as approximately 10% of non-performing loans secured by real estate.

In the worse case scenario, if state chartered banks had to charge off all non performing assets, only six institutions would end up below the 3% leverage ratio recently proposed by the Comptroller of the Currency.

Such a situation is highly improbable, particularly in light of portfolio distribution. The composition of the portfolio, the coverage afforded by the allowance for loan losses, and the level of equity capital, are matters of comfort not concern.

As for the savings and loan industry, I would like to take just a moment to address the condition of Connecticut's state-chartered thrift industry. There are nine state-chartered savings and loans with total assets of $839 million. Each of these institutions has capital ratios in excess of 4% of total assets based on generally accepted accounting principles. The asset structure of these institutions is dominated by real estate loans, specifically loans on one to four-family residential properties. Their financial condition is sound and generally reflects the condition of state-chartered banks.

In closing, I would like to emphasize that Connecticut's state-chartered banks are being examined and supervised in an effective and timely fashion. The capabilities of the Connecticut Department of Banking have been recognized nationally. Connecticut was one of the first states to be accredited for its performance by the Conference of State Bank Supervisors, the professional organization of state officials who charter, examine, supervise and regulate the state-chartered commercial and FDIC-insured savings banks.

The Department of Banking has developed an internal monitoring system based on the analysis of off-site data, which facilitates the scheduling of examinations. Special attention is paid to institutions that have problems such as deteriorating asset quality, declining earnings or capital dissipation.

In addition to the examination process, I personally maintain a close working relationship with the various state banking organizations and have an open door policy with all the institutions under my supervision. The combination of effective and timely examinations, and direct personal communication with banking organizations and bankers on an individual basis enhance the regulatory process.

ADDENDUM TO TESTIMONY OF HOWARD B. BROWN BANKING COMMISSIONER, STATE OF CONNECTICUT

To supplement my oral testimony, I am providing the following to more thoroughly respond to the questions the Committee has asked me to address:

1. **Are you satisfied that the state chartered commercial banks and savings banks that you oversee have enough capital to protect the public interest and avoid a future crisis at the insurance fund?**

... The level of primary capital, which includes equity capital and the allowance for loan losses, is strong and improving. As of June 30, 1989, Connecticut had 54 state chartered commercial banks and 64 state chartered savings banks, all of which were FDIC (BIF) insured. These 118 institutions had aggregate assets and primary capital of $55.9 billion and $4.8 billion, respectively. The ratio of primary capital to total assets was 8.67%, up from 8.58% at year end 1988. The 54 commercial banks had total assets of $16.8 billion and a primary capital ratio of 8.22%, compared to 7.91% as of December 31, 1988. The 64 savings banks had aggregate assets of $39.1 billion and a primary capital ratio of 8.86%, nominally lower than the December 31, 1988 level of 8.88%. Every institution had a primary capital ratio in excess of 6% of total assets.

Furthermore, Connecticut state chartered banks have traditionally been involved in residential real estate lending. As of June 30, 1989, 20% of the total assets of commercial banks and 48% of the total assets of savings banks were invested in loans secured by one to four-family residential properties. Since this type of loan will fall into the 50% category under risk based capital guidelines, state chartered institutions will also be highly capitalized under this method of calculation.

Systemwide, the capital to asset ratio has increased from 8.58% as of December 31, 1988 to 8.67% through the second quarter of 1989. The annualized growth rates indicate that capital will continue to grow at a 10% rate; however, the anticipated increase in assets is only 8%. Assuming a normal earnings trend, primary capital should continue to increase both in actual dollars and as a percentage of total assets.

2. **Are you confident that earnings reported at these institutions reflect their true earnings performance?**

... Earnings reported by state chartered banks continue to reflect the true results of operations. Reports are prepared according to generally accepted accounting principles and are in conformance with FDIC reporting procedures.

The 54 commercial banks had an aggregate return on assets of 0.95% for 1988, which was consistent with levels for prior years since 1984. The annualized return through June 30, 1989 declined to 0.47% principally because one institution expensed a significant special provision through its loan loss account in order to provide additional funds to its allowance for loan losses. Barring this special situation, the average annualized return on assets through the first six months would have been consistent with prior periods. Annualized earnings for the 64 savings banks were 0.79% through June 30, 1989, the same as was recorded for 1988.

Much has been made of the recent downturn in earnings for institutions in the Northeast. However, at least for Connecticut state chartered institutions, the facts indicate that earnings depletion is not endemic to the entire industry. Exclusive of nine new banks that have been open for less than two years and have not yet attained profitability, only 4 of the state chartered banks had deficit earnings through the first six months. The losses incurred by two of the four can be directly attributed to extraordinary charges made to the loan loss reserve in order to prudently provide additional funds to the loan loss reserve. Each of these four institutions has primary capital in excess of 7%.

A further analysis of the earnings trend of the 118 state chartered banks indicates that 62 have average or above earnings; 15, which are below average, have higher annualized earnings for the first six months than for 1988; 16, which are below average, have been open for less than 5 years; 3, which are below average are recently converted thrift institutions; 18 are operating profitably but have lower than average earnings; and 4 report losses as noted above. In light of the fact that state chartered banks have increased their loan valuation reserves from $252 million or 0.60% of total loans as of year-end 1988 to $325 million or 0.75% as of June 30, 1989, earnings are generally satisfactory.

3. **Do you have any concerns about the portfol~~io~~ composition at these institutions?**

... The loan portfolio for the 118 state chartered banks aggregates $43.5 billion which represents 78% of total assets. Real estate loans total $32.9 billion and represent 76% of the entire portfolio. $22.3 billion of total real estate loans, which account for 51% of total loans and 40% of total assets, are secured by 1-4 family residential properties. Commercial and consumer loans account for the vast majority of the remainder of the portfolio. Commercial loans total $6 billion and represent 14% of the portfolio and instalment loans aggregate $4 billion, which is 9% of total loans. Loans to finance leveraged buyouts and those extended to foreign borrowers account for a negligible portion of credit extensions.

As I mentioned previously, state chartered banks maintain an allowance for loan losses totaling $325 million, which represents 0.75% of total loans. Net of residential real estate loans, the allowance is 1.53% of total loans. The allowance account also represents 38% of total non-performing loans. Since 66% of total non-performing loans are secured by real estate, the existing loan loss reserve maintained by state chartered banks is sufficient to fully cover 100% of all non-performing unsecured loans as well as approximately 10% of non-performing loans secured by real estate.

In the worse case scenario, if state chartered banks had to charge off all non performing assets, only 6 institutions would end up below the 3% leverage ratio recently proposed by the Comptroller of the Currency.

Such a situation is highly improbable, particularly in light of portfolio distribution. The composition of the portfolio, the coverage afforded by the allowance for loan losses, and the level of equity capital, are matters of comfort not concern.

4. Are you satisfied that state chartered commercial banks and savings banks are being examined and supervised in an effective and timely fashion?

... State chartered banks are being examined and supervised in an effective and timely fashion. The capabilities of the Connecticut Department of Banking have been recognized nationally. Connecticut was one of the first states to be accredited for its performance by the Conference of State Bank Supervisors. The Department has developed an internal monitoring system based on the analysis of off-site data, which facilitates the scheduling of examinations. Special attention is paid to institutions that have problems such as deteriorating asset quality, declining earnings or capital dissipation.

In addition to the examination process, I maintain a close working relationship with the various state banking organizations and have an open door policy with all the institutions under my supervision. The combination of effective and timely examinations, and direct personal communication with banking organizations and bankers on an individual basis enhance the regulatory process.

5. What is your record with regard to initiating, and accomplishing your goals for, enforcement actions?

... In the past few years, various enforcement actions have been initiated and accomplished both independently and jointly with federal regulators. These actions range from Memoranda of Understanding, to Adoption of Formal Resolutions by Boards of Directors, to removal of officers of operating institutions and directors of institutions in organization, to the successful negotiations of potential proxy challenges, to the sale of problem federal and state institutions. It is worthy to note that such actions have been instrumental in maintaining Connecticut's record of not having placed a state chartered institution in receivership for well over a decade, in spite of some turbulent economic conditions.

6. **What is your forecast of the conditions of state chartered banks and thrifts under your jurisdiction for the next year?**

... I expect that the 118 state chartered banks and 9 state chartered savings and loan associations will maintain their sound financial conditions and continue to operate in a satisfactory manner. Obviously, general economic conditions, particularly, real estate development both commercial and residential, will be a major factor in how well financial institutions perform. If conditions do not improve significantly, it is likely that earnings and capital enhancement will be relatively flat. The general prognosis seems to indicate that the local real estate market will not improve significantly for another year or so. However, as my earlier testimony indicated, state chartered institutions are financially sound and should be well able to withstand an extended period of sluggishness.

I would like to take a few moments to address the condition of Connecticut's state chartered thrift industry which consists of 9 savings and loan associations with total assets of $839 million. Each of these institutions has a capital ratio in excess of 4% of total assets based on generally accepted accounting principles. The asset structure of these institutions is dominated by real estate loans specifically, loans on 1 to 4-family residential properties. Their financial condition is sound and generally reflects the condition of state chartered banks.

7. **What plan of action do you have to remedy any deficiencies you perceive in your state?**

... The deficiencies which exist in the Northeast are generally problems which are beyond the ability of financial institutions to solve independently. The basic problem as I have mentioned is a downturn in the real estate market. The best plan of action is to be sure that state chartered banks and thrifts continue to operate prudently by building reserves and capital and managing their portfolios in a conservative manner. I will continue to maintain an aggressive examination and supervision profile and to deal pro actively with institutions under my jurisdiction.

The CHAIRMAN. Thank you very much, Mr. Brown.

Mr. Lewis.

STATEMENT OF GERALD LEWIS, COMPTROLLER, STATE OF FLORIDA

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Chairman, Senator Mack, I am Gerald Lewis, comptroller of the State of Florida. In that capacity, I serve as the regulator of State-chartered banks, savings and loan associations, and credit unions and also as the regulator of the securities industry which I mentioned because I'd like to raise a point in a moment.

I appreciate the opportunity to be here and I know I speak for all of us when I say we are very pleased that you are seeking input from state regulators and making us a part of the process.

I have supplied written answers to your questions and I hope that they will be helpful.

I'd like to, if I may, make one point that I feel very strongly about.

Mr. Chairman, Senator Mack, I think that we must maintain the good, close working relationship between Federal and State regulators that we have had over the years if our banking system is going to remain strong. My experience with the FDIC has been excellent over the years and I have been in this office since the beginning of 1975.

I think that is essential because none of us has all the wisdom in the world and none of us has all the resources in the world. When you combine the resources that we have I think we come to the best possible solution. Again, our experience with the FDIC has been very positive. The FDIC has moved swiftly when necessary with institutions that have been troubled or need to be closed or taken over.

Recently we worked with the FDIC to recapitalize two insolvent commercial banks and I think those are the two that were alluded to in earlier testimony by members of the academic community which indicated there are three insolvent Florida banks. I would respectfully suggest that that information is not current and we have taken care of those situations of those two institutions. The third one is a very small $10 million institution. But working with the FDIC we were able to get additional capital for those two banks and it's been a very happy experience.

I say that because in all candor I cannot tell you that we have had the same satisfactory relationship in the past with FSLIC. In fairness to them, I think part of their problem was a lack of resources, both financial and personnel. But let me give you one example, if I may, Mr. Chairman.

The Freedom Savings and Loan Association of Tampa, FL became insolvent in July of 1986. By October of 1986, with no prospect for recapitalization, Freedom's negative GAAP net worth reached $41.8 million. We requested FSLIC to place that institution into receivership. Almost a year later, mid-February of 1987, with no action forthcoming, Freedom's negative net worth had gone from almost $42 million to $76 million. At that time I personally came to Washington to meet with the acting director of FSLIC and at that meeting I again urged that FSLIC come in and take over this institution which was losing money rapidly.

We also have four other insolvent savings and loans——

The CHAIRMAN. Can I just back you up there for a minute? Senator Mack may have a question on this as well. Was it common to have a situation where you as a State regulator felt that an institution ought to be closed or subjected to some kind of disciplinary or restraining action and then not have that carried out by the federal regulators? Did you ever have to, after such a delay, literally come to Washington and seek action?

Mr. LEWIS. Mr. Chairman, it was common with FSLIC. It has not been common with FDIC. Again, in fairness, they were strapped for resources. The answer at one time was, "We have other bigger problems in other States and we just can't handle it all."

The CHAIRMAN. And how many times would you have done that, would you estimate? You've given one case. Were there others?

Mr. LEWIS. There were four other insolvent associations.

The CHAIRMAN. Where you actually had to finally come to Washington and try to trigger action here?

Mr. LEWIS. That is correct. Other members of the staff had been dealing with members of FSLIC.

The CHAIRMAN. When would that have happened?

Mr. LEWIS. I came up in mid-February of 1987 and again I'm going to commend the then acting director of FSLIC who had been with the Atlanta office, which is our regional office, and who I had worked with closely over the years, and I know the dilemma that he was at and I attribute to him the fact that they finally did take action. It was very frustrating to see the time go by with no action taken. Again, understanding the situation he was in, he had been brought to Washington as acting director in route to a promotion as president of the Home Loan Bank somewhere in the Midwest and I forget now. Coming back to Tallahassee I was surprised to see him on the airplane to Atlanta and asked what he was doing and he said, "Well, I haven't moved my family up yet because I was supposed to be there only for a brief period of time. That brief period of time has turned into 14 months and I don't know when I'm going to be transferred to my permanent assignment." So again, I understand the human limitation but it was just a frustrating experience.

Senator MACK. If I may just raise a question.

The CHAIRMAN. Sure.

Senator MACK. Gerry, do you feel there was any other solution to this problem of Freedom Federal beyond FSLIC? Was there something within the control of the State other than just—I really would ask you at this point could you just literally have closed them down?

Mr. LEWIS. Senator, we do not have the financial means to do that. We must have the insurer to act with us. We just don't have the resources.

Senator MACK. You really didn't have any leverage over them to say that this problem was one that should have received a greater priority than what they had placed on it?

Mr. LEWIS. No, sir. I think looking back at it probably the acting director did what he could considering all that was on his plate at the time, but as every day went by there were great losses.

Senator MACK. Thank you.

Mr. LEWIS. Frustration did continue beyond that, though. Freedom's losses continued to mount and finally in September of 1988 there was interest shown by a group that wanted to acquire Freedom and here the story becomes somewhat curious because the Home Loan Bank Board was dealing with the investor group unilaterally and independently of our office. We knew nothing about it. My recollection is that we found out about it from the investor group because FSLIC had taken over the institution and had converted it to a Federal savings and loan. Amazingly, though we were not a party to the negotiations between the Home Loan Bank and the investor group, the deal appeared to be dependent on conversion to a State-charter because of the expanded powers that we gave to State-chartered institutions. In other words, the investor group was not interested in acquiring Freedom unless it could be converted to a State-chartered institution.

When we found this out, we were somewhat perplexed because the chairman of the Home Loan Bank was routinely criticizing the States for expanded powers and I'm not saying that as an argument but just as a fact. We wrote a letter just candidly asking—our general counsel wrote a letter candidly asking about this. "We know how you feel about expanded powers. Why are you encouraging Freedom to convert to a State charter," which was the only way the deal was going to go through?

We never received an answer to that and about a month or so later I was in Washington and met with the Chairman of the Home Loan Bank Board and we just posed the question to him rather directly: "What is your position?" And his answer was, "I have never really said that State expanded powers were the problem. I have said expanded powers of both State and Federal institutions combined with lack of the ability to regulate adequately," and he said, "Usually only the first sentence is quoted and I don't get quoted on the rest."

I said, "But what is your position on Freedom?" He said, "Well, we're not really taking a position."

The CHAIRMAN. May I just interrupt at that point? Let me just indicate to Senator Graham who's just come in what you've just been saying. Mr. Lewis indicated that on at least four cases that occurred during his stewardship in this position there were savings and loans in Florida that were under water and losses were accumulating—I'm trying to give a fair summary so correct me if you disagree—and he became so alarmed about it that on more than one occasion he approached the Federal regulators and asked them to intervene and act in that situation, because of the risks and the mounting losses that he saw. He was just finishing a description in the case of the Freedom savings and loan which was I guess the worst of the four, but it's a very telling indication of the fact that for a variety of reasons the Federal authorities were either unable or unwilling to act in these cases. This occurred in this case even though the State regulator was beating on the door to try to get something done.

Is that a fair summary?

Mr. LEWIS. Yes, sir, it is.

The CHAIRMAN. So that may be of interest to you.

Mr. LEWIS. Eventually the investor group that was interested in Freedom withdrew their application and the losses just continued to mount literally as I said with every day. They were losing over one-third of a million dollars every day. Just last week the RTC did settled Freedom and now that is resolved.

The reason I mentioned this, Senator Graham, I said that I feel very strongly about the necessity for cooperation between Federal and State regulators. I've seen it work as with our relationship with the FDIC. I've also seen it work in another area and that's why I mentioned securities regulation.

We have a problem not just in Florida but nationally regarding penny stock fraud.

Senator MACK. Gerry, could I just interrupt before you get into that. I just have one more question.

Prior to Freedom becoming almost a household word in the sense of the problems that everyone could see, what role did you and your office play in determining what the weaknesses of Freedom were and how early did you contact the Federal Home Loan Bank Board or FSLIC with respect to your concerns about this institution?

Mr. LEWIS. I would have to go back and look at the chronology. We were certainly aware that it was troubled for a period of time and were working with FSLIC. We both were aware of it. Sometimes there just isn't anything you can do and this was that kind of a case. It was not possible to recapitalize. There were no sources of capital. At that time we did not have authority to do anything until an institution was insolvent. The Florida legislature has given us more power this last session and we can now move somewhat earlier. We don't have to wait until insolvency. We can move on eminant insolvency but at that time there was not anything we could do.

Just very briefly I was going to say on the penny stock situation, Florida has been a leader in fighting penny stock fraud. Having said that, the reason we've been successful is that we've had an amazingly cooperative relationship with the SEC, the FBI, the U.S. attorney in Miami. I'm trying to think of any other agencies. I say amazingly. You just don't see this kind of cooperation on a regular basis. It is a working relationship at the field level. Our investigators, FBI, SEC field personnel work together on a regular basis so that we're constantly sharing information so we coordinate our efforts. We don't trip over each other. Chairman Ruder was so pleased with the success we've had he has done that around the country to set up task forces to combat penny stock fraud.

Again, I use that as an example because I think the same thing is true in the banking area.

I'd like to make two final points and I'll close. It's our opinion that in Florida most of the failures of savings and loans were due to mismanagement and/or fraud. One of the strong features I feel about FIRREA is the money appropriated for criminal prosecution. In Florida we're putting the wrongdoers in jail. We've been successful in several cases, again in a cooperative effort. One of our investigators worked literally for several years with the Assistant United States Attorney from Mr. Leyton's office in Miami and successfully prosecuted wrongdoers who caused the failures of S&L's.

We also have gotten tough on money laundering in Florida. We believe that we have eliminated money laundering from the Telelines. But the drug traffickers are very sophisticated and they have moved to other areas. I again feel this is an area that we need cooperation between the Federal Government, State governments—maybe we're especially sensitive to it in Florida because of our geographic location and because of our geography, the thousands of miles of coastline which I know both Senator Graham and Senator Mack are aware of. We're just very aware of the problem and we're trying to do what we can at the regulatory level to fight that.

We have taken a no-nonsense approach to money laundering and we've had good cooperation again from the Federal authorities and I think that's absolutely essential. Thank you again for letting me be with you.

[The complete prepared statement of Gerald Lewis follows:]

OFFICE OF COMPTROLLER
STATE OF FLORIDA
TALLAHASSEE
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GERALD LEWIS
COMPTROLLER OF FLORIDA

TESTIMONY CONCERNING
THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY
IN THE UNITED STATES

BY FLORIDA COMPTROLLER GERALD LEWIS

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

October 17, 1989

Mr. Chairman, members of the Committee, I am Gerald Lewis, Comptroller of the State of Florida. In that capacity I serve as the Commissioner of all state-chartered financial intermediaries: banks, savings and loan associations and credit unions. I am also the chief state securities regulator for Florida.

I thank you for the opportunity to share my perspective concerning the condition of the banking industry. I, as you, do not believe that one person or agency has all the necessary answers to resolve the weighty issues before us. I appreciate the fact that the committee has exhibited their confidence in the dual banking system, and the regulators within it, by making us an integral part of the process.

I have supplied written responses to the seven questions that the Committee is concerned with today. I hope that my answers serve you well. You have indicated that you are interested in the ability of the current regulatory structure to effectively examine, supervise and regulate the banking industry. The current structure's ability to enforce existing law is also an area of interest. In my remarks, I would like to address these concerns.

As a regulator of both banks and savings associations, I believe I have a unique perspective of the differences between bank and savings association regulation in our country. That perspective leads me to believe that we must maintain the high level of cooperation that has existed between state and federal bank regulators. That cooperation is an important component in the relatively healthy state of the banking industry, compared with the current state of our savings associations.

When the charterer and insurer of a financial institution cooperate, the decisions made regarding the fate of the institution are based upon an appropriate balance of the concerns of both state and national regulators. When balanced, the examination, supervisory, human and financial resources of each regulator are more effectively utilized. If not balanced, the decisions of one regulator may be made without full knowledge of the situation.

Our experience with the FDIC over the years has been very positive. If an institution was determined to be insolvent there was never any hesitation, on our side or theirs, to move swiftly and decisively to limit the impact to the insurance fund. Recently, we worked together and successfully recapitalized two insolvent commercial banks, thereby avoiding any loss to the consumer or the insurance fund.

Our experience with the FSLIC over the years was less than satisfactory. The FSLIC recognized our need to close insolvent associations. Resource constraints, however, caused by mounting losses from years of delayed FHLBB action, simply prohibited them from resolving their caseload.

By way of illustration, I would like to discuss Freedom Savings and Loan Association, Tampa, Florida. This association became insolvent in early July 1986. By October 1986, with no prospect for recapitalization, Freedom's negative GAAP net worth reached $41.8 million. My office requested that the FSLIC place the association into receivership.

In mid-February 1987, with no action forthcoming and Freedom's negative net worth exceeding $76 million, I personally came to Washington to meet with the acting director of the FSLIC. At that meeting, I urged the FSLIC to close not only Freedom, but four other insolvent associations. Again, while the acting director understood our position, the agency lacked the human and financial resources to accommodate our request.

By July 1987, one year after insolvency, the association's negative net worth had reached $90.1 million. At that time, Freedom was placed into receivership, rechartered as a federal association, and allowed to continue operation.

Over the next year, fully two years after insolvency, Freedom's losses continued to mount and the FHLBB tried to sell the association. Acting unilaterally, and in ways that directly impacted my office, the FHLBB during September 1988 gave preliminary approval to an investor group to acquire Freedom.

Amazingly, we were not party to the FHLBB acquisition discussions with the investor group, even though potential conversion to a state charter, with its expanded investment powers, was being used as an enticement. Interestingly, at the same time the FHLBB was lambasting several western states for perceived risks associated with expanded investment powers.

While we appreciated the FHLBB's confidence in our ability to supervise and regulate expanded powers, the process was less than effective since there was a complete absence of coordination and communication with the state regulator. Eventually, the investor group withdrew its acquisition application and losses continued to mount at Freedom.

As of June 30, 1989, over 1,000 days after we declared the association insolvent, Freedom's exposure to the deposit insurance fund reached $370 million -- representing a loss of over one-third of a million dollars a day!

The purpose of this discourse is to point out that in the area of financial institution regulation, timing is everything. Regulators must be able to make prompt decisions and to take prompt action. In Freedom's case, as in so many other cases nationwide, a quick resolution could have substantially reduced the exposure to the insurance fund.

With the establishment of the RTC, I am concerned that we are now faced with increased possibilities for communication breakdown, and that FIRREA will cause new delays in the resolution of insolvent banks. The creation of additional reporting layers above the FDIC, and the FDIC's additional RTC responsibilities, have hampered that agency's ability to move with speed and flexibility.

For instance, in order to prepare a bid package for a small, imminently insolvent Florida commercial bank, the FDIC initially planned to use liquidation staff from the New York region who were unfamiliar with the bank's history. Although a local liquidation crew was eventually identified, the use of out-of-area staff could have delayed the eventual closing of the bank and increased potential losses to the bank insurance fund.

As a final chapter to the Freedom saga, the ineffectiveness and apparent disorganization of the recent RTC bidders' meetings associated with Freedom created the impression of a process in disarray. This is in sharp contrast to previous highly professional and highly structured FDIC bid meetings. The last-minute postponement of the RTC bid process for Freedom cost both potential bidders and the insurance fund precious time and money.

In summary, FIRREA has added additional, and perhaps unnecessary, layers to the regulatory decision-making process, which have the potential to slow the resolution of insolvent banks and savings and loans. Although I fully support the intent of the thrift bailout plan, I believe it is important that we do not replicate the problems of the FHLBB with the FDIC and destroy the regulatory ability of a well managed agency. As a state regulator, my department is willing to help while federal resources continue to be strained. Our institutional knowledge alone can help expedite the bidding process, if those with that knowledge at the federal level are spread too thin.

I would also like to briefly address another area which needs the renewed, more vigorous and more cooperative interest of Congress and the other states. That area is money laundering and the detrimental impact it has on the economic health of this country and the well-being of every citizen.

My office and the Florida banking industry, along with state and federal law enforcement agencies, have worked to virtually eliminate money laundering at the teller line. Nearly a decade ago, we launched a major assault on the problem of money laundering, even before it became a popular topic. In 1981, Florida began an intensive compliance examination program at our financial institutions. In October 1984, Florida enacted a state currency transaction reporting requirement. Then, earlier this year at my urging, the Florida legislature strengthened non-compliance and money laundering penalties.

We are now investigating possible alternatives for detecting money laundering schemes involving wire transfers and other electronic means. The new and preferred method of cleaning dirty money involves electronic transfers of drug profits around and out of this country. The trail of illicit profits is nearly impossible to follow if it is moved through use of wire transfers. But, Florida cannot work in a vacuum. The tracking of possible laundering schemes involving wire transfers must be addressed at all levels -- local, state, national, and international. That is why I am calling for the support of all regulatory and investigatory agencies to work together to detect new money laundering vehicles. I also urge you to ensure that the states are not excluded from federal investigatory and information sharing systems designed to combat this problem.

We are proud of our cooperative efforts regarding money laundering, and we are convinced that the best approach to maintain safety and soundness is through a deliberate, coordinated, and cooperative effort on the part of all regulators. We stand ready to meet that challenge.

GERALD LEWIS
COMPTROLLER OF FLORIDA

OFFICE OF COMPTROLLER
STATE OF FLORIDA
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32399-0350

PREPARED REMARKS CONCERNING
THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY
IN THE UNITED STATES

BY FLORIDA COMPTROLLER GERALD LEWIS

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

October 17, 1989

THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY
IN THE UNITED STATES

Prepared Statement By Gerald Lewis
Comptroller, State of Florida
For the U. S. Senate Banking Committee
October 17, 1989

1. **Are you satisfied that the state-chartered commercial banks and savings banks that you oversee have enough capital to protect the public interest and avoid a future crisis at their insurance fund?**

Generally, yes. Although there are individual exceptions, I believe the Florida banking industry's capital base is adequate to preserve the public interest and protect the deposit insurance fund. Traditionally, capital funds have been plentiful in Florida. I am also the regulator of the Florida securities industry and I have seen firsthand that there is no shortage of capital funds. In fact, Florida has more registered agents than any other state in the nation and Florida ranks third in terms of the number of registered securities firms. This points toward a solid and strong asset base in our state.

Florida's asset base is supported by the substantial wealth and growth of the state's population. Some of this country's strongest commercial banking firms have a solid presence in Florida. A recent McKinsey and Company report indicates that superregional banking firms have actually increased their capital base 6.8 times during the period 1982 - 1988. At the same time, money center banks have only increased their equity 1.6 times. Two of the seven superregionals specifically identified for their outstanding performance have a dominate presence in Florida. SunTrust Banks, Inc. and Barnett Banks, Inc. have a large share of state-chartered commercial banks in Florida and these are two of the banking firms which are expected to become dominant players during the 1990's.

Although there is no shortage of capital funds, there appears to be a general reluctance to allocate additional funds to the banking industry. I believe this reluctance is based largely on the current crisis in the savings and loan industry. The public has associated the precarious condition of the thrift industry with the overall condition of the banking industry.

The general hesitation to allocate additional capital funds to the Florida commercial banking industry has resulted in an increase in the number of approved but unopened de novo banks that are unable to raise the required capital. Although this has had a detrimental impact on regulators' efforts to recapitalize problem institutions, in the long run this type of market discipline will be beneficial for the industry.

Perhaps the most effective way to establish market discipline within the financial institution industry is through risk based capital measures. I wholeheartedly support the risk based approach recently instituted by the federal regulators. The adoption of risk based capital measures acknowledges that asset quality must be taken into consideration when determining capital adequacy. Risk based capital standards will institute market discipline in a manner that is consistent with sound regulation.

But, market discipline also calls for equitable and uniform market competition. It is imperative that the commercial banking industry be allowed to compete on an equal footing with nonbanking firms and foreign financial institutions. The investor perception that banks are currently at a competitive disadvantage vis-a-vis securities and insurance conglomerates is one factor inhibiting commercial banks from attracting capital. I urge you not to let the savings and loan crisis impede your efforts to expand banking powers in a manner that does not create a danger to the deposit insurance fund. Congress must continue to break down the barriers between the banking industry and its competitors through expansion of bank powers.

I believe it is the responsibility of the states to enact deliberate but sound regulations to foster growth and expansion of the banking industry and the economy. In Florida, we continue to focus our efforts on maintaining sound legislative parameters for state-chartered banks. At my urging, the Florida legislature recently made changes to the banking statutes that I believe will go a long way toward strengthening capital and public confidence in the industry.

De novo capital requirements were doubled effective October 1, 1989. These increased initial capital requirements reduce potential threats to the deposit insurance fund, in that they place more investment funds at risk. Banks are also prohibited from paying shareholder dividends if operating losses occurred during the previous two years, or if capital is inadequate. Banks must also reserve for reasonably anticipated future losses before dividends can be declared and paid.

The Florida legislature also approved my request to close insolvent banks before capital has been completely exhausted. Effective October 1, 1989, I have been given the authority to close any bank that has less than one percent of capital. We will be able to respond more quickly to problem situations, and this will reduce losses that could eventually erode the deposit insurance fund.

One concern I have for future capital levels nationwide is the impact of FIRREA on the industry. If we are to depend on the commercial banking sector to absorb a large percentage of the thrift deposit base, either through acquisition or through a shift of deposits, the banking industry must be able to attract additional capital to support this growth. In Florida, we are monitoring this situation closely so that we can respond swiftly to unexpected asset growth that is not supported by corresponding capital growth.

2. Are you confident that earnings reported at these institutions reflect their true earnings performance?

In my experience, most commercial banks accurately report and reflect their true earnings. As a part of our examination procedures, the examiners review and analyze reported income and expenses at each examination. This type of financial analysis is a crucial part of our examination process and the examination staff can easily identify inaccurate or misleading data. During each examination, income and expenses for several years are checked against the bank's records and any material discrepancies are reported to management. Amended information is required to be prepared and submitted to the appropriate regulators. This amended information is then available for public scrutiny.

Although most banks accurately report and reflect their true earnings, there are several situations that may lead to overstatement of a bank's income. The best way to deal with these situations is through identification and adjustment during the final analysis.

One situation we see from time to time that can cause misstated earnings involves the use of interest reserves for acquisition, development and construction (ADC) loans. Quite often in ADC lending, banks will fund interest charges during the construction period by setting up interest reserves. In the short run, the use of these reserves overstates income and assets, since the bank is actually funding its own interest income, and in the worse case the loan is not collected and must be charged-off.

Other examples include capitalization of income earned not collected (IENC) on delinquent or non-performing loans, inadequate loan loss reserves and other unrecognized losses. Banks that have subsidiary operations may accurately reflect overall earnings performance, but it is possible to mask individual institution performance. Income from bank operations can be significantly different from consolidated income in some instances.

From a regulatory standpoint, as long as earnings are properly evaluated, these potential situations are not difficult to deal with. In Florida, I believe we have a good handle on institution profitability. The examination staff has received specific training on how to analyze income and expenses in relation to the institution's overall balance sheet. We also require each bank to submit information to the Department that allows us to identify situations that may cause reported earnings to be misleading. If we are armed with the appropriate information, from a regulatory standpoint we can deal with these types of unique situations.

3. Do you have any concerns about the portfolio composition (particularly investments in real estate, LBOs and LDC lending) at these institutions?

Most bank portfolios are well diversified since Florida's economy is not dependent on a single industry for growth and development. Most of Florida's institutions have well diversified portfolios and are not involved with LBOs and LDC lending. One lending problem we have been watching closely is acquisition, development and construction lending (ADC) and its impact on a commercial bank's bottom line.

ADC lending is a type of specialized lending that has become more popular since deregulation. Generally, ADC loans carry greater risk than traditional commercial lending activities and banks appropriately price these loans at higher interest rates. The higher costs of deposits can be offset by the higher return on ADC loans.

In Florida, several examiners have developed special expertise in the evaluation of ADC loans. This has helped us to identify problems associated with ADC loans early and we have been able to respond quickly.

During the last four years, the state has closed eleven banks, three of them for abuses or mismanagement of ADC lending [i.e. Park Bank (2/14/86), County Bank (3/13/87) and Caribank (12/9/88)]. Currently, one institution is close to insolvency primarily as a result of its ADC lending activities. But, these are isolated instances and do not reflect the lending decisions of most of Florida's banks.

We are also closely evaluating real estate investments, such as joint ventures and other direct real estate loans. As a result of normal market fluctuations, during the last few years we have seen some softening in the real estate market in Florida, especially on commercial real estate projects. So far, we have not seen any major negative impact on Florida bank portfolios, but we are urging management to diversify their portfolios when appropriate.

Another area we are watching closely involves the volume of home equity loans and adjustable rate mortgages in bank portfolios. These instruments were developed in response to deregulation of the liability side of the balance sheet. Although adjustable rate instruments are beneficial to the industry, any significant upturn in interest rates has the potential to force excessive delinquencies, bankruptcy and foreclosures. Again, early identification and quick response are crucial to effectively managing any potential adverse consequences.

4. Are you satisfied that state-chartered commercial banks and savings banks are being examined and supervised in an effective and timely fashion?

Under most circumstances, I believe we are doing a good job in supervising Florida's state-chartered commercial banks. You can always increase examination and supervision to make the process more effective, but there are real world constraints.

Our examination and supervisory efforts have been recognized by the Conference of State Bank Supervisors through their accreditation program. Three years ago today, the Florida banking department was the sixth state in the nation to receive accreditation from CSBS. Since our original accreditation in 1986, we have undergone two annual reviews.

My office works closely with other state and federal regulators. For example, for the last three years we have met with the FRB, OCC, the FDIC, and state regulators to coordinate our examination efforts of regional holding companies. We are currently scheduling a multi-state, multi-agency effort to examine the two largest regional bank holding companies later this year. We have also participated in quarterly Interagency Supervisory Conferences (FRB, OCC, FDIC, and OTS). These workshops are designed to identify common supervisory problems.

The FDIC recently reduced the number of routine examinations of state-chartered banks it performs in order to concentrate its efforts on the thrift crisis. The FDIC's presence in problem savings and loan associations reduced the number of personnel available to conduct routine non-problem bank examinations. This placed a greater burden on the state banking departments to perform quality examinations. My office has worked closely with the FDIC and the FRB and we have picked up a greater portion of the bank examination load.

As institutions are liquidated by the Resolution Trust Corporation, increasing numbers of FDIC personnel should be freed up to perform routine bank examinations. I expect the FDIC will gradually return to its previous level of bank examination and the states will continue to operate at current levels. Increased state supervision, combined with previous federal levels of supervisory oversight, should strengthen the overall supervisory efforts of bank regulators.

As with other state and federal regulators, we continue to face and deal with problems such as high turnover, low salaries and funding problems, which can lead to shortages of highly qualified staff. We have begun to use computerized examination procedures and we are supplementing examination information with enhanced off-site monitoring. These procedures have increased our efficiency and our overall level of supervision. We are also looking at integrating our bank and savings and loan examination functions to strengthen our overall supervisory capabilities. We have also increased our training efforts and are constantly reviewing our funding and salary situations.

5. **What is your record with regard to initiating and accomplishing your goals for enforcement actions?**

In Florida, I have authority to initiate final enforcement actions and this authority is used when warranted. During the last five years, we have taken or participated in the following enforcement actions:

	Cease & Desist Orders	Memorandums of Understanding	Removal Orders	Other**
1989(YTD)	4	4	3	12
1988	6	9	0	14
1987	4	16	3	14
1986	8	14	6	11
1985	5	9	1	5

** Includes board resolutions and written agreements.

Of course, the issuance of final enforcement actions does not always result in obtaining desired results. Although enforcement goals are always in the best interest of the bank, management may be unable or unwilling to accept and correct deficiencies. Enforcement actions are ineffective if stockholders or others are not willing to recapitalize a bank or are unwilling to take other corrective action. But, we have found that early detection and identification of problems, and management acceptance of those problems, are essential to correct deficiencies and reduce the likelihood of serious regulatory problems later. During the last few years, we have been able to deal with problems more quickly, and we are often able to obtain results without having to take formal action.

At my urging, the Florida legislature has just strengthened my enforcement powers to reach "others participating in the affairs of the institution." Also, administrative fines have been increased and extended to "others" and removal orders issued as a result of criminal activity will now become final in certain instances. These legislative powers are important since stockholders, attorneys, CPA firms or other outsiders can have significant influence over the affairs of an institution. In several recent cases in Florida, non-insiders have directly contributed to operating difficulties at various institutions. I believe these legislative changes will go a long way toward reducing abuses which until now have been outside the reach of state authority.

In Florida, we will have the opportunity to take a thorough look at our banking code and, if appropriate, make necessary changes to strengthen particular statutes. During 1991, the banking statutes come up for a legislatively mandated review and will be repealed unless continued or amended. This process, known as "regulatory sunset", occurs every ten years and provides the department the opportunity to review every aspect of our banking regulations. I have asked industry representatives, academicians, members of the legislature, as well as members of consumer groups to help me with this effort. I believe our combined knowledge and expertise will result in legislation that will make the Florida banking industry stronger, safer, more competitive, and thereby provide a stable economic climate which also benefits the consumer.

6. What is your forecast of the condition of state-chartered banks and thrifts under your jurisdiction for the next year?

Florida's banking industry is strong compared with most states. We have seen a healthy resurgence of the community bank and continued strengthening of the superregional holding companies. According to recent American Banker figures, return on assets and return on equity for five of the top ten bank holding companies with assets of 20 billion dollars or more have a strong presence in Florida. Two of these superregional companies, Barnett Banks, Inc. and SunTrust Banks, Inc., have a their roots in Florida and have a high proportion of their assets held by state-chartered subsidiaries. Superregional capital growth and earnings performance continues to out perform the money center banks. During the 1990's, the superregionals are expected to become dominant competitors of the money center banks.

Overall economic conditions are moderate in Florida, but our economy is built on diverse industries. A downturn in one segment of the economy will not have the devastating effects that many states have experienced. But, many of the problem banking situations in Florida have been the result of outright fraud, as opposed to economic or industry problems.

The number of problem banks in Florida has been on the rise, but I believe the worst may be behind us. There are quite a few larger banks operating in the state that have the financial where-with-all to absorb potential failing banks. Bank portfolios are diverse, with a general lack of concentration of LDC lending and LBOs.

With FIRREA, there is a lot of uncertainty about the future of the industry. I believe we will probably see a shift in the number of banks and S&Ls, as the institutions become more homogeneous. Numbers of institutions will probably decline slightly, but I do not foresee massive disintermediation in the industry. Overall, I believe the banking industry as we have known it will probably take on new dimensions. I expect to see the industry to be more service oriented, and there will be stronger and more viable institutions in the future.

The banking industry of the future will be strengthened significantly by expanding permissible bank powers. Congress and the states must allow banks to competitively operate in our current environment. There are antiquated laws on the books that were designed to insulate the banking industry from competition from non-bank financial firms. Although laws restricting competition may have been appropriate when initially enacted, they do not seem to be effective in today's environment. The barriers have been relaxed for non-bank financial firms, while the commercial banking industry has been held to strict laws that do not allow it to compete on an equal footing with non-bank financial firms.

A stronger, more competitive banking industry will lead to a stronger and more uniform system of deposit insurance. Expanded powers will provide commercial banks with a vehicle to produce needed income. This will cause overall profitability and capital levels to increase, which will appropriately put more investor funds at risk, and not the funds of depositor's and taxpayer's.

7. What plan of action do you have to remedy any deficiencies you perceive in your state?

I do not see any serious deficiencies in Florida's banking industry, but there is a lot of uncertainty about future trends facing the industry. This includes numbers of commercial banks and savings and loan associations and the size and complexity of these institutions. As bank regulators, we cannot sit idly by and let the industry change around us. Our efforts must be flexible enough to allow us to effectively respond to whatever the future may bring. I believe the banking regulator motto for the future will be "proactivity, not reactivity."

In Florida, we have been taking a critical look at our efforts and we have studied ways to increase our supervisory capabilities. For the last nine months, we have been looking closely at our commercial bank and savings and loan examination report and procedures. Personnel from the bank and savings and loan examination areas have identified ways to strengthen both examination processes. One recommendation suggests a need for more generic examination and supervision of Florida's banks and savings and loan associations.

In addition to examination procedures, we are also looking closely at our regulatory structure to identify options that are available to more effectively and efficiently utilize our human and financial resources. This may include cross training of examination personnel and realignment of supervisory responsibilities. Cross utilization of the technical strengths of our savings and loan and bank examination staff can be an important first step to make regulation of the Florida banking industry more effective.

As previously discussed, the Florida banking statutes will be subject to a statutorily mandated review by the Florida Legislature in 1991. I believe this is an excellent opportunity to review our current regulations and to make changes that will strengthen the banking industry in Florida. To accomplish this goal, I have appointed a task force of industry representatives and other interested parties to take a hard look at our current banking statutes. The task force will determine what changes, if any, are necessary to the banking statutes to ensure a competitive, but safe and sound banking industry in Florida.

GERALD LEWIS
COMPTROLLER OF FLORIDA

OFFICE OF COMPTROLLER
STATE OF FLORIDA

TALLAHASSEE
32301-8054

July 29, 1988

Mr. William D. Hussey
President
Florida League of Financial Institutions
825 N. Garland Avenue, Suite 300
Orlando, Florida 32802

Dear Bill:

Thank you for your July 5, 1988, letter requesting information on savings and loan failures in Florida. Comptroller Lewis has asked me to respond to your inquiry. This office appreciates your efforts to defend our statutes and Florida's rights as they pertain to financial institution regulation. This office will support you in any way we can and as such I am providing you some background material which I hope will be of some assistance to you.

The question you pose regarding whether the FSLIC should be responsible for insuring deposits in states where state laws are more liberal than Federal laws is certainly valid, given the bludgeoning that our laws have received in the press over the last few months.

Our evaluation indicates that the ability of state-chartered financial institutions in Florida to diversify has generally enhanced institutional profitability, and has thus been a net benefit to our State. According to the findings of state and federal examiners, recent Florida failures are the result of faulty management decisions and, in some instances, outright fraud. There is no evidence that state-chartered institutions in Florida pose a greater risk to the deposit insurance fund than our federal counterparts. As such, speaking for Florida, we see no basis for withholding deposit insurance from state-chartered institutions solely on the basis of their investment powers.

We can find in our research no justification for the unsubstantiated charge that the current difficulties within the industry are primarily the result of state-chartered institutions. Across the nation, an equal proportion of federal and state thrifts are currently insolvent.

As you will see from the enclosed analysis, the current situation in Florida is substantially different from that of Texas or California. We find the constant grouping of Florida thrift institutions with Texas and California to be inequitable, unsubstantiated, and without merit.

The Florida/Texas/California correlation implies that this office has provided poor regulatory enforcement and oversight to the state-chartered thrifts in Florida. To the contrary, it is important to remember that the four state-chartered thrifts that were declared insolvent and transferred to the FHLBB during 1987 were closed as a result of the demands of this office. Nearly a year before their closing, Comptroller Lewis urged the FHLBB to take immediate steps to merge or otherwise deal with the insolvent institutions. If this office had not demanded that the FSLIC take receivership of these institutions, it is likely that the institutions would still be in operation. If these institutions were allowed to continue operation, public confidence could have been further undermined and the operating losses could have rapidly increased the costs that would have to be borne by the FSLIC, the savings and loan industry, and ultimately, the citizens of Florida.

We are optimistic about Florida's thrift industry. While we are still experiencing some difficulties with specific institutions, we have confidence in the increasing expertise exhibited by our examination staff. Your industry's support during our efforts to achieve sizable increases in examiner salaries has contributed to our ability to keep quality personnel.

We would appreciate any help you can provide to help to temper comparisons of Florida thrift institutions with other states. Again, I hope these thoughts and the enclosed material are helpful to you. Please contact me if you need further assistance.

Sincerely,

Terry Straub

Terry Straub
Assistant Director

TMS/wdj

Enclosures

Thrift Insolvency in the United States

Many articles have recently been written alluding to the impact expanded powers at the state level have had on the current plight of the thrift industry. Texas, California and Florida are most often mentioned as the states with the most liberal thrift investment powers. There is a preconceived notion that liberal investment statutes in these three states are the primary cause of the high level of insolvencies and failures within the industry. This notion naturally leads to the conclusion that the current thrift difficulties are due to problems within state-chartered as opposed to federally-chartered institutions.

The purpose of this working paper is to examine the premise that state-chartered thrifts are primarily responsible for the difficulties in the industry. A second purpose of this paper is to examine whether the level of insolvency and failure in Florida is of a magnitude sufficient to place that state in the same class as Texas and California. Lastly, the paper evaluates the extent to which there is a correlation between the use of expanded investment powers and thrift failure or insolvency.

Thrift Insolvency and Failure is not Predominately a State-Chartered Problem

Insolvency in the thrift industry is defined for the purposes of this paper to include those institutions that have negative regulatory capital, as reflected by Sheshunoff Rating Services, Inc., S & L Quarterly, as of December 31, 1987.

Exhibit 1 of this paper indicates that as of December 31, 1987, 340, or 10.77% of all federally-insured thrift institutions were insolvent. An approximately equal share of federally and state-chartered thrifts had a negative regulatory net worth as of that date (187 of 1723 (or 10.85%) federal and 153 of 1433 (or 10.68%) state thrifts).

In 1986 and 1987, 61 federal thrifts with assets of $19.3 billion and 66 state thrifts with assets of $17.8 billion were either closed by the Federal Home Loan Bank Board (FHLBB) or were involved in an FHLBB transaction, again pointing to an approximately equal proportion of federal and state problem institutions within the nation (Exhibit 2).

Thrift Failure and Insolvency in Florida is not on Par with Texas or California

Exhibit 1 also indicates that seventeen states had a higher proportion of thrifts with negative regulatory net worth than Florida at the end of 1987. The State of Texas had 108 insolvent thrifts by this definition, or 38.7% of Texas thrifts were insolvent. This contrasts sharply with Florida's experience (17, or 11.4% of Florida thrifts had a negative regulatory net worth). Twenty-eight of California's 207 thrifts were insolvent (13.5%) at the end of 1987. Although the percentage of insolvent California thrifts is roughly the same as Florida thrifts, the average asset size of each insolvent California thrift is 29 percent larger than the average insolvent Florida thrift. Therefore, the potential adverse impact to the deposit insurance fund is far greater from California thrift insolvencies than from Florida thrift insolvencies.

There is no Close Correlation Between the Use of Expanded Investment Powers and Thrift Insolvency or Failure

Florida thrift investment laws are often referred to as permissive, since Florida S&Ls may invest in any activity that is approved by the Department. Florida's investment statutes are often given as the reason for the state-chartered savings and loan failures in Florida. Similarly, the difficulties experienced by California and Texas savings and loans are often attributed to the more liberal investment powers available to state-chartered institutions in those states.

Section 665.0701(3), Florida Statutes, allows up to 20 percent of the total assets of the investing association to be invested in stock, obligations, or other securities of service corporations or other corporations or entities. California statutes allow up to 100 percent of total assets to be invested in such entities, while Texas statutes allow such investments to reach 10 percent of total assets. In contrast, federal statutes allow federally-chartered savings and loan associations to invest up to 3 percent of total assets in service corporations or other corporations or entities.

As of the end of last year, twelve, or twenty percent of state-chartered Florida thrifts had a level of investment in service corporations or other corporations or entities that exceeded the 3 percent maximum that would be allowed within a federal thrift. In the aggregate, these institutions had a return of assets of 0.49% and a capital to asset ratio of 4.87%. Both of these measures compare favorably with the .02% return and 4.47% capital/asset ratio experienced by those institutions with little or no investment in service corporations (Exhibit 3).

The lack of subsidiary investments has done nothing to insulate a state-chartered thrift from losses within Florida. A greater percentage (47.9%) of those thrifts with little or no investment involvement experienced losses during 1987, in comparison to thrifts with levels of service corporation and subsidiary investment greater than 3% (Exhibit 3).

In fact, the aggregate impact of service corporation and subsidiary investments by Florida state-chartered thrifts was positive. Net income generated from investments in service corporations amounted to an aggregate of $132 million in 1987 (Exhibit 4).

The Causes of Recent Florida Failures

Seven state-chartered Florida thrift institutions have been transferred to the Federal Savings and Loan Insurance Corporation within the past five years. Four of these institutions were closed in 1987 at the demand of the Florida Department of Banking and Finance. The failure of these institutions, as outlined in examination reports, was the result of the following factors:

1. High concentrations of acquisition, development and construction loans;
2. Unsafe and unsound lending practices:
    a. inadequate appraisals;
    b. loans in excess of appraised value;
    c. circumvention of loans to one borrower regulations;
    d. failure to evaluate credit worthiness;
    e. inadequate borrower equity;
    f. poor loan underwriting and administration; and
    g. concentration of out-of-territory loans;
3. Excessive growth in deposits and subsequently loans with inadequate controls;
4. Failure to maintain adequate records;
5. High level of management compensation;
6. Lack of knowledge of rules and regulations associated with the industry;
7. Disregard for the examination and supervisory process; and,
8. Fraud.

The misuse of investment powers did not play a major role in the failure of any state-chartered institution within the last five years.

EXHIBIT I

THRIFTS WITH NEGATIVE NET WORTH

STATE	ABSOLUTE			PERCENT		
	STATE	FEDERAL	TOTAL	STATE	FEDERAL	TOTAL
ALABAMA	0	2	2	0.00%	100.00%	8.33%
ALASKA	0	1	1	0.00%	100.00%	33.33%
ARIZONA	1	0	1	100.00%	0.00%	8.33%
ARKANSAS	4	9	13	30.77%	69.23%	35.14%
CALIFORNIA	15	13	28	53.57%	46.43%	13.53%
COLORADO	1	6	7	14.29%	85.71%	19.44%
CONNECTICUT	0	1	1	0.00%	100.00%	3.45%
DELAWARE	0	0	0			0.00%
DC	0	0	0			0.00%
FLORIDA	9	8	17	52.94%	47.06%	11.41%
GEORGIA	0	4	4	0.00%	100.00%	5.80%
HAWAII	0	0	0			0.00%
IDAHO	0	1	1	0.00%	100.00%	14.29%
ILLINOIS	7	16	23	30.43%	69.57%	8.71%
INDIANA	2	7	9	22.22%	77.78%	7.96%
IOWA	1	7	8	12.50%	87.50%	16.00%
KANSAS	2	6	8	25.00%	75.00%	14.55%
KENTUCKY	0	3	3	0.00%	100.00%	4.48%
LOUISIANA	3	15	18	16.67%	83.33%	18.75%
MAINE	0	0	0			0.00%
MARYLAND	1	2	3	33.33%	66.67%	3.13%
MASSACHUSETTS	0	0	0			0.00%
MICHIGAN	1	1	2	50.00%	50.00%	4.00%
MINNESOTA	0	6	6	0.00%	100.00%	16.67%
MISSISSIPPI	2	3	5	40.00%	60.00%	11.90%
MISSOURRI	1	3	4	25.00%	75.00%	4.94%
MONTANA	0	1	1	0.00%	100.00%	9.09%
NEBRASKA	0	4	4	0.00%	100.00%	17.39%
NEVADA	0	0	0			0.00%
NEW HAMPSHIRE	0	0	0			0.00%
NEW JERSEY	4	3	7	57.14%	42.86%	5.11%
NEW MEXICO	1	4	5	20.00%	80.00%	20.00%
NEW YORK	0	0	0			0.00%
NO. CAROLINA	1	0	1	100.00%	0.00%	0.73%
NO. DAKOTA	0	0	0			0.00%
OHIO	2	1	3	66.67%	33.33%	1.35%
OKLAHOMA	3	17	20	15.00%	85.00%	27.74%
OREGON	1	4	5	20.00%	80.00%	31.25%
PENNSYLVANIA	0	0	0			0.00%
RHODE ISLAND	0	0	0			0.00%
SO. CAROLINA	0	1	1	0.00%	100.00%	2.04%
TENNESSEE	1	4	5	20.00%	80.00%	7.94%
TEXAS	78	21	99	78.79%	21.21%	35.48%
UTAH	0	2	2	0.00%	100.00%	15.38%
VERMONT	0	0	0			0.00%
VIRGINIA	0	2	2	0.00%	100.00%	2.99%
WASHINGTON	1	3	4	25.00%	75.00%	10.26%
WEST VIRGINIA	0	2	2	0.00%	100.00%	11.11%

Source: SHESHUNOFF INFORMATION SERVICES, INC.

EXHIBIT II

CLOSED THRIFTS AND FHLBB-ASSISTED TRANSACTIONS
1986 - 1987

	CLOSED THRIFTS		FHLBB TRANSACTIONS		CLOSURES AND TRANSACTIONS	
	NUMBER	ASSETS (000)	NUMBER	ASSETS (000)	NUMBER	ASSETS (000)
CHARTER						
FEDERAL	14	3,433	47	14,346	61	17,779
STATE	23	5,641	43	13,657	66	19,298
	37	9,074	90	28,003	127	37,077
STATE						
ARKANSAS	2	50	0	0	2	50
ALABAMA	0	0	2	232	2	232
ARIZONA	1	1,680	3	1,011	4	2,691
CALIFORNIA	6	849	12	4,450	18	5,299
COLORADO	1	42	3	352	4	394
DISTRICT OF COLUMBIA	0	0	1	1,100	1	1,100
FLORIDA	2	1,575	5	2,540	7	4,115
IOWA	1	160	0	0	1	160
INDIANA	0	0	2	535	2	535
ILLINOIS	2	434	5	2,468	7	2,902
KANSAS	1	83	3	153	4	236
KENTUCKY	0	0	1	471	1	471
LOUISIANA	7	898	13	2,919	20	3,817
MASSACHUSETTS	0	0	1	525	1	525
MARYLAND	1	115	0	0	1	115
MICHIGAN	0	0	1	361	1	361
MISSOURI	1	184	3	1,035	4	1,219
MISSISSIPPI	1	50	0	0	1	50
NORTH CAROLINA	0	0	1	126	1	126
NEW JERSEY	1	39	1	184	2	223
NEW MEXICO	0	0	1	20	1	20
NEVADA	1	14	1	53	2	67
NEW YORK	0	0	1	468	1	468
OHIO	0	0	8	2,554	8	2,554
OKLAHOMA	1	135	6	981	7	1,116
OREGON	2	179	1	263	3	442
SOUTH CAROLINA	0	0	1	80	1	80
TEXAS	3	2,383	6	3,595	9	5,978
UTAH	1	121	1	400	2	521
VIRGINIA	0	0	2	335	2	335
WASHINGTON	1	23	2	493	3	516
WISCONSIN	0	0	1	181	1	181
WEST VIRGINIA	0	0	1	138	1	138
WYOMING	1	60	0	0	1	60
TOTALS	37	9,074	90	28,003	127	37,077

SOURCE: SHESHUNOFF INFORMATION SERVICES INC

EXHIBIT III

No.	Name	Equity Inv in Service Corps to Total Assets	Equity Inv in Service Corps	Net Income	Regulatory Capital	Total Assets	ROA	Capital/Assets
125	First Federated Savings Bank	25.53%	36423	-6975	-38243	142686	-4.89%	-26.80%
156	Miami Savings Bank	11.54%	20496	3416	5661	177581	1.92%	3.19%
158	CenterBanc Savings Association	9.80%	117349	4100	119359	1197290	0.34%	9.97%
162	Ambassador Savings & Loan Association	8.34%	16496	2170	10273	197801	1.10%	5.19%
128	CenTrust Savings Bank	8.33%	669076	69209	404164	8031733	0.86%	5.03%
148	Cypress Savings Association	8.31%	16815	-6850	231	202290	-3.39%	0.11%
140	American Pioneer Savings Bank	7.03%	140518	8308	77369	1997603	0.42%	3.87%
129	Life Savings Bank	4.93%	6932	615	4980	140564	0.44%	3.55%
136	Lincoln Savings & Loan Association	4.89%	12947	-1494	5844	264723	-0.56%	2.21%
149	Anchor Savings Bank	3.75%	7682	1515	8957	205054	0.74%	4.37%
117	American Savings & Loan Association	3.74%	112552	5949	156016	3012663	0.20%	5.18%
146	Community Savings Bank	3.34%	6104	1377	12890	182769	0.75%	7.05%
	Totals	7.39%	1163390	77000	762511	15753764	0.49%	4.87%
143	Commonwealth Savings & Loan Association	2.94%	45264	-896	47756	1540695	-0.06%	3.10%
124	Andrew Jackson State Savings	2.57%	4226	1618	10518	164600	0.98%	6.39%
138	Marine Savings & Loan Association	2.56%	3269	-1836	5088	127769	-1.44%	3.98%
175	Suncoast Savings & Loan Association	2.33%	2536	1871	13593	108727	1.72%	12.50%
164	FirState Savings & Loan Association	2.23%	4097	1656	10734	183551	0.90%	5.85%
141	International Savings & Loan Association	1.58%	1573	-444	3905	99288	-0.45%	3.93%
173	Pioneer Savings Bank	1.50%	32058	6807	63646	2138383	0.32%	2.98%
184	Atico Savings Bank	1.17%	4545	-733	24650	387528	-0.19%	6.36%
131	Brickellbanc Savings Association	1.13%	598	-1291	-3484	53149	-2.44%	-6.56%
177	Professional Savings Bank	0.72%	5014	1334	27263	698664	0.19%	3.90%
187	Fortune Savings Bank	0.66%	19447	13073	113172	2950558	0.44%	3.84%
157	Peoples First Financial Savings & Loan	0.61%	927	861	10530	151685	0.57%	6.94%
134	Home Savings Association of Florida	0.20%	1780	11900	80324	882305	1.35%	9.10%
172	Great Life Savings Association	0.15%	80	-338	3199	52371	-0.65%	6.11%
154	Royal Palm Savings Association	0.10%	531	-11061	17537	531923	-2.08%	3.30%
169	PCA Savings & Loan Association	0.09%	75	44	5011	81778	0.05%	6.13%
127	Goldome Savings Bank	0.08%	1328	-14313	72150	1735773	-0.82%	4.16%
142	First Presidential Savings & Loan Assn	0.05%	74	598	4569	139796	0.43%	3.27%
167	Gold Coast Savings & Loan Association	0.04%	53	224	8600	145514	0.15%	5.91%
178	Nova Savings & Loan Association	0.01%	5	155	3054	37224	0.42%	8.20%
145	First Venice Savings & Loan Association	0.01%	5	-1069	-3726	63131	-1.69%	-5.90%
189	Sovereign Savings Bank	0.01%	1	-333	2803	17872	-1.86%	15.68%
152	Central Savings & Loan Association	0.00%	1	-460	919	28809	-1.60%	3.19%
181	Bay Savings Bank	0.00%	0	-215	2170	36516	-0.59%	5.94%
176	Crown Savings Association	0.00%	0	916	9081	111816	0.82%	8.12%
186	Bay Financial Savings Bank	0.00%	0	609	6038	100386	0.61%	6.01%
179	Madison Savings & Loan Association	0.00%	0	393	7508	67847	0.58%	11.07%
183	Partners Savings Bank	0.00%	0	-68	2637	18593	-0.37%	14.15%
188	Consumers Savings Bank	0.00%	0	-500	3893	27568	-1.81%	14.12%
155	Charter Savings & Loan Association	0.00%	0	640	6530	109584	0.58%	5.96%
168	Republic Savings & Loan Association	0.00%	0	261	5149	100492	0.26%	5.12%
185	Truman Savings and Loan Association	0.00%	0	-370	2682	21995	-1.68%	12.19%
161	Gibraltar Savings & Loan Association	0.00%	0	-3838	4033	57141	-6.72%	7.06%
153	Financial Security Savings & Loan Assn	0.00%	0	-2383	-5249	190003	-1.78%	-2.76%
194	Sterling Savings Bank	0.00%	0	-944	3245	27764	-3.40%	11.69%
171	InterBanc Savings & Loan Association	0.00%	0	183	4696	44168	0.41%	10.63%
174	Destin Savings Bank	0.00%	0	161	3369	33966	0.47%	9.92%
193	Coral Savings & Loan Association	0.00%	0	-1048	3086	14786	-7.09%	20.87%
170	Turnberry Savings & Loan Association	0.00%	0	320	3347	44302	0.72%	7.55%
192	Union Savings Bank of Florida	0.00%	0	140	2425	35757	0.39%	6.78%
144	Fort Brooke Savings & Loan Association	0.00%	0	817	4327	98759	0.83%	4.38%
165	Guardian Savings & Loan Association	0.00%	0	2046	7451	135706	1.51%	5.49%
191	Palm Plaza Savings Association	0.00%	0	-489	2229	16250	-3.01%	13.72%
195	Bankers Savings Bank	0.00%	0	-106	2948	8710	-1.22%	33.85%
182	Pointe Savings & Loan Association	0.00%	0	-821	3573	34034	-2.41%	7.56%
180	Murdock Savings Bank	0.00%	0	-169	3320	36106	-0.47%	9.20%
166	United Savings Association	0.00%	0	325	7767	111407	0.29%	7.00%
114	Surety Building & Loan Association	0.00%	0	158	1222	13841	1.15%	8.83%
	Totals		127,486	2,390	618,313	13,818,588	0.02%	4.47%

Source: FEDERAL HOME LOAN BANK OF ATLANTA
FLORIDA DIVISION OF BANKING

EXHIBIT IV

IMPACT OF SUBSIDIARY OPERATIONS

ON FLORIDA STATE-CHARTERED THRIFTS

NO. Institution	Income From Subsidiary Operations	Income From Conventional Operations	Total Income
128 CenTrust Savings Bank	$118,104	(48,895)	69,209
187 Fortune Savings Bank	$2,079	10,994	13,073
134 Home Savings Association of Florida	$373	11,527	11,900
140 American Pioneer Savings Bank	$4,663	3,645	8,308
173 Pioneer Savings Bank	$4,011	2,796	6,807
117 American Savings & Loan Association	($16,993)	22,942	5,949
158 CenterBanc Savings Association	$5,378	(1,278)	4,100
156 Miami Savings Bank	$8,116	(4,700)	3,416
175 Suncoast Savings & Loan Association	($185)	2,056	1,871
164 FirState Savings & Loan Association	$1	1,655	1,656
124 Andrew Jackson State Savings	$685	933	1,618
149 Anchor Savings Bank	($414)	1,929	1,515
146 Community Savings Bank	$634	743	1,377
177 Professional Savings Bank	($171)	1,405	1,234
157 Peoples First Financial Savings & Loan	($69)	930	861
129 Life Savings Bank	$1,396	(781)	615
142 First Presidential Savings & Loan Assn	$96	502	598
168 Republic Savings & Loan Association	($5)	266	261
167 Gold Coast Savings & Loan Association	$107	117	224
178 Nova Savings & Loan Association	$4	151	155
172 Great Life Savings Association	$41	(279)	(238)
184 Alico Savings Bank	$500	(1,223)	(723)
143 Commonwealth Savings & Loan Association	$1,912	(2,808)	(896)
145 First Venice Savings & Loan Association	($65)	(1,004)	(1,069)
136 Lincoln Savings & Loan Association	($2)	(1,492)	(1,494)
138 Marine Savings & Loan Association	$93	(1,929)	(1,836)
162 Ambassador Savings & Loan Association	($422)	(1,748)	(2,170)
161 Gibraltar Savings & Loan Association	($467)	(3,371)	(3,838)
148 Cypress Savings Association	($373)	(6,477)	(6,850)
125 First Federated Savings Bank	($2,319)	(4,656)	(6,975)
154 Royal Palm Savings Association	($314)	(10,747)	(11,061)
127 Goldome Savings Bank	$7,592	(21,904)	(14,312)
TOTALS	$132,087	($48,802)	$83,285

Source: FEDERAL HOME LOAN BANK OF ATLANTA
FLORIDA DIVISION OF BANKING

The CHAIRMAN. Very good. I appreciate what's being said here. It's so interesting to see how each of the States tend to do it quite differently. Now in your State you have pretty much the whole waterfront of financial services. I gather you do not have insurance. I think you have an insurance commissioner in Florida, but you've got everything from securities across to banks and savings and loans. Yet in California there's clearly a split between the S&L's on the one side and the banks on the other.

You've lived now, Mr. Lewis, for some time with the broad waterfront. Is it your view that there are some important advantages to that kind of a system? Obviously each State has to look at that question, but I'm wondering if in the kind of modern world of finance that we live in whether there might not be some wisdom in having somebody on top who really looks at all the principal financial service sectors at once that are State-chartered, so that you can make sure that all are in some rough balance and healthy simultaneously.

Mr. LEWIS. Well, I wouldn't speak for any other State, Mr. Chairman. I think it has served Florida well. I think it does give us that broad perspective and so I feel it's good for us.

The CHAIRMAN. Let me just ask you before going to Mr. Littlefield, Mr. Gilleran. You've got the divisions. Have you ever thought that there might be some wisdom in a consolidation?

Mr. GILLERAN. Consolidation is something that's been considered in California for a number of years and is still being considered and we're going through all of the necessary discussions with the various parties you have to have to bring something like that about. But there's definitely we feel advantages to it if it can be accomplished within the system.

The CHAIRMAN. Very good.

Senator BOND. Mr. Chairman, may I ask leave to present Mr. Littlefield?

The CHAIRMAN. Please do.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Because it was my great pleasure to recruit Ken Littlefield from the office of the Comptroller of the Currency after 13 years experience there to be Commissioner of Finance in Missouri. He served 4 years there in difficult economic times, but Missouri came out very well, thanks to his good leadership. I had great confidence in his judgment. Then when he told me he was taking this position in Texas I thought I would rethink it, but he has had an excellent background and I know he's taken on a very difficult assignment in Texas. I am pleased and proud to have him before this committee and join the rest of my colleagues in looking forward to his comments on what's going on in Texas.

The CHAIRMAN. Well, I appreciate that comment by you. If you're the guy that picked this guy out, we know he's good. It sounds like Texas is the greater for that.

Mr. Littlefield, we would like to hear from you now.

STATEMENT OF KENNETH W. LITTLEFIELD, BANKING COMMISSION, STATE OF TEXAS

Mr. LITTLEFIELD. Thank you very much, Chairman Riegle and distinguished members of the committee. I think Senator Bond might first question my judgment on moving to Jefferson City from San Franciso where I had a view of the bay with the OCC, but I appreciate your kind comments, Senator Bond.

It's a pleasure for me to be here to present my perspective on some of the issues facing this committee. They are certainly very critical issues and over the next several years many of them have to be resolved.

What I thought I would do is very quickly give you a brief overview of the state of the banking industry in Texas, give you some of my views about what are some of the breakdowns and some of the causes of the situation down there, and then tell you what I think are some of the lessons that we've learned and some things that we need to do and indeed the banking department has done to adjust to that.

First, the condition of the industry. There are 1,414 banks in Texas. That's State and national banks as of June 30, 1989; 656 of those banks are State-chartered banks. That's 47 percent of the total banks in Texas and 22 percent of the banking assets. State banking assets are $40 billion as of June 30.

It's no secret that we've had a lot of bank failures in Texas; 314 in fact since 1984. There have been 851 failures nationwide during that period of time so the bank failures in Texas since 1984 represent 37 percent of the total failures nationwide.

Through September 30, 1989, there were 113 bank failures in Texas. That's equal to 70 percent of the total bank failures nationwide.

It's a little irony that as of that date the bank failures for 1989 equaled the total number of bank failures for 1988 with one quarter yet remaining in 1989.

Problem banks—and I'm speaking here only of state-chartered banks that I'm responsible for—peaked at about December 31, 1988 at 187 four and five rated banks. That's 27 percent of the total banks that I'm responsible to regulate.

As of September 30, 1989, that number had decreased to 167 problem banks, which is equal to 26 percent of the total banks that I'm responsible for.

On the other hand, three rated banks which are potential problem banks, the first stage of problems, as of September 30th was at 152, which equaled another 24 percent of the banks that I am responsible for. If you add those two percentages together it's exactly 50 percent of the banks in Texas are either serious problem banks or potential problem banks.

It's also important to note I think the schedules I presented indicate that that's been relatively steady now for the last 2 years so that as we're moving banks off the problem list through failure and merger and other means there have been other banks to replace those.

From the standpoint of earnings, Texas banks, state and national banks, lost $5.6 billion in the 3½ years ending June 30, 1989.

That's one-third of the year-end 1985 equity capital, 1985 being the last year that banks earned a profit.

The State-chartered banks are operating at a profit for the first 6 months of 1989 and were at about a break-even point for the year 1988.

I've given you a list of commonly cited reasons for bank failures. I would just like to emphasize that in my judgment all these reasons are factors. We try to sometimes simplify problem by coming up with one reason that banks fail. I don't think it's one reason. There are a number of reasons why they fail and I've listed them down here.

Let me just emphasize one and that is the collapse of the real estate and energy industries in Texas has played a dramatic role in the number of problem banks and bank failures that we've seen. Even banks that have traditionally and historically been sound and well-managed are having financial difficulty in Texas today.

Fraud and insider abuse has been a problem and I'm sorry to say that I think it's more of a problem now than it has been in the past. I think this is because as banks run out of capital and managements are struggling to hang on to their financial assets that they are willing to get into the bank's assets and take them inappropriately. We've seen, in my judgment, a rise on insider abuse and fraud in the last year and we are working diligently with the Federal authorities and with the FBI and other prosecutorial agencies to try to identify the fraud and to eradicate it from the banking system and we feel very strongly about that and I think we've made some progress but it's an uphill battle. I throw my support behind the actions of Congress in strengthening and improving the funding for the FBI, for the U.S. Attorney's Office. My only concern is that it was not enough. There's a number of situations that need to be prosecuted that have been laying there for several years and I think we need to get those folks and get them where they belong.

We've talked a little bit and listed what some of the internal and external problems are that caused the banking problems, but I'd like to focus a little bit on some of the control factors.

Even if the marketplace is bad and even if the economy is bad and we have fraud and insider abuse there are control factors to protect the banking industry. Those have not worked well either in Texas and I'll just list them.

Market controls. The market discipline did not work. Indeed, as I pointed out, some of the banks in Texas that have now failed were the darlings of Wall Street and market analysts were highly touting their high performance as a model for the nation.

Accounting controls didn't work either. Indeed, we didn't see a lot of big CPA firms raising red flags and questioning the lending activities that were going on in Texas.

State and Federal congressional oversight and legislative oversight didn't have its finest hour in Texas either.

Finally, what I want to spend most of my time discussing is the ultimate control factor and that's regulatory oversight. I think it was not our finest hour either in terms of regulatory oversight for the banking industry.

Let me begin by saying that I think our regulatory focus has traditionally been—well, it's pretty much the same that it's been since the 1930's, but our examination procedures and techniques are essentially the same as they were during a regulated banking environment. That is, we focus on loan quality. Our examination procedures and indeed our CAMEL rating factor is all driven by the asset quality of the bank. Examiners go in and pour through those credit files and come up with a list of classified loans and then we make determinations about capital adequacy. Earnings obviously are poor at that time and liquidity problems sometimes trails that.

These are all trailing indicators, Mr. Chairman, and I think our focus has been on looking at problem loans rather than problem banking practices. As long as we focus on problem loans we're going to be finding problems that the genesis of that problem was several years prior to——

The CHAIRMAN. We're going to be behind the curve constantly.

Mr. LITTLEFIELD. Exactly. So I think that has been the major misdirection of our examination procedures and techniques is to focus on trailing indicators. As I said, the whole CAMEL rating system or the CAMEL system that the FDIC uses are all trailing indicators. Indeed a high performance bank is a leading indicator to a future problem. So when earnings turn poor, that's after the fact and after the problem has already occurred.

So we have tried to redirect that focus in our regulatory responsibilities in Texas and we're trying to focus on leading indicators that are potential problems for the banking industry. I didn't list all those in my testimony and I'd like to give them to you real quickly.

The CHAIRMAN. Please do. It's very important and I welcome your thinking here.

Mr. LITTLEFIELD. Number one is growth and any time we have a bank that has a high growth situation I believe that's a leading indicator. Regulators need to be concerned about that growth, monitoring the growth and looking at it to see if it's safe and sound growth, whether it's in loans or deposits.

Significant changes in asset composition, whether it's a significant change of a loan portfolio, a significant change in the securities portfolio, either maturities or content of that portfolio, that's a leading indicator.

Any significant change in a bank's management usually indicates it's going to have a change in policy and direction and that's a leading indicator.

A change in ownership often accompanied by ownership debt is a leading indicator. If there's a lot of ownership debt and high leverage there, there's a tendency to stretch for earnings for the bank and perhaps engage in riskier ventures.

High earnings that I've already mentioned is a leading indicator.

High interest rates—if we find a bank that's paying higher than normal interest rates on its deposits structure, that would be a leading indicator. If a bank is achieving a higher yield on its loan portfolio than its peer group, that would be a leading indicator because there is a direct relationship between risk and reward.

Lack of internal controls is a very significant leading indicator in a bank. If we find a bank that doesn't have good internal controls, regulators ought to be very quick to criticize the bank and take corrective actions.

Lack of sound policies and procedures in a bank is a leading indicator. A bank may be very well managed by an individual, a small bank, without good policies and procedures, but I assert there could be a festering problem waiting to come up in the future.

Concentrations of credit. We saw that the real estate loans in Texas banks increased dramatically in the early 1980's, particularly in commercial real estate loans. I think a good regulatory posture would have been to monitor that and when we saw that increase and concentration to have taken a more critical view of it.

Finally, insider lending. Any time we see a bank that's willing to lend money to itself and to its insiders in a large way, we need to pay particular attention to that.

Those are some of the leading indicators that I think we have to pay more attention to in the future and be more pro active in our regulatory posture there.

[The complete prepared statement of Kenneth W. Littlefield follows.]

Testimony of

Kenneth W. Littlefield

Banking Commissioner of Texas

Before the

U. S. Senate
Committee on Banking, Housing and Urban Affairs

One Hundred and Second Congress

Given October 17, 1989

Dirksen Senate Office Building

Washington, D.C.

SUMMARY

The financial industry in Texas has traversed the gamut from high performance banking to highly publicized disaster. Like a theme park thrill ride, the industry has taken a fast-paced trip from the crest of a tall wave into a deep trough. That overused quote from Dickens about the "best of times and worst of times" seems all too fitting. Texas has amassed impressive statistics -- on both ends of the spectrum.

Texas banking is not yet out of the woods. The number of failures for 1989 will set a new record. In the first nine months alone, Texas has posted as many failures as in all of 1988. Failures of major, multi-bank holding company organizations have obviously skewed the numbers; but even on an adjusted basis, the numbers are record book material.

In the aftermath, many have asked, "Why?" I submit, Mr. Chairman and members of the Committee, that the answer lies in several factors and in a breakdown of four control systems. My testimony includes a brief listing of the more commonly cited failure reasons. Some of the reasons are external in nature, others are internal; not the least of them is mismanagement. After all, in the final analysis, all failures can be related to the discretionary decisions of management.

In addition to recognizing the interrelationships of the various factors, it is necessary to appreciate the amplification effect which external factors have on internal management decisions. It is also very necessary that we recognize the importance of the results which can occur when regulatory control systems cease to be effective. By studying the factors and system failures which led to and fostered the financial industry crisis, we have now learned that our regulatory methodologies needed to change just to keep pace with a dynamic and highly competitive banking industry.

Traditionally, we as regulators had focused on trailing indicators and had identified symptoms of problems rather than leading indicators and the causes of problems. We regulated primarily by reaction rather than through anticipation. The flaw to this methodology was that our medicine was being applied well after the disease had incubated into a serious malady.

Methods of supervision and regulation are evolving to focus on banking practices which have the potential for producing unacceptable individual or systemic risks. The focus today is on management's policies and practices, not just on their performance. Policies and practices are usually the precursors of that which is to follow while performance may be the masked results of a buoyant economy.

We at the Texas Department of Banking, have taken positive steps to redirect our supervisory techniques. Some of our initiatives in this regard include: flexible examination procedures designed to concentrate regulatory resources on banking aspects having the highest potential for risk; portfolio management and quarterly monitoring designed to enhance and expedite our identification and regulatory response to bank conditions; comprehensive management evaluation guidelines designed to more thoroughly and objectively assess the quality of management and management practices; strengthened enforcement powers designed to deal more effectively with onerous banking managers or practices; and last but far from least, a renewed emphasis on communication skills so that we can be more effective in achieving our regulatory objectives.

All of the above evolving techniques have the common thread of applying that ounce of prevention rather than the costly pound of cure. We are striving to convert the educational experiences of the past into more intelligent methods for the future. There will always be room for refinement and improvement, but there must never again be an environment which permits a repeat of history.

Mr. Chairman and members of the Committee, I am grateful for the opportunity to respond to your questions and offer my perspectives. Thank you.

INTRODUCTION

Mr. Chairman (Donald W. Riegle, Jr.), members of this Committee, my name is Kenneth W. Littlefield. I am the Banking Commissioner of Texas. I was appointed to this position on December 5, 1986. Prior to that time, I gained 17 years of bank regulatory experience, 13 with the Comptroller of the Currency in the Midwest, Washington D.C., and San Francisco, and four years as Commissioner of Finance with the Missouri Department of Finance. Most recently I spent two years as an executive officer of a Missouri bank holding company having five banks and a mortgage banking subsidiary. Our total assets were $250 million and we serviced approximately $250 million in first mortgage loans.

As Banking Commissioner of Texas, I am responsible for the supervision and regulation of approximately 650 state-chartered banks. In addition, I have supervisory authority over 350 trust companies and trust departments of commercial banks, 19 foreign bank agencies, 217 preneed and perpetual care facilities, and 28 sale of checks licensees.

As of June 30, 1989, total commercial banking assets in the State of Texas were $182 billion, held in 1,414 state and national banks (includes $14 billion in four "collecting" banks). Total loans were $93 billion and total deposits were $147 billion. Looking just at state-chartered banks, there were 656 state banks holding $40 billion in assets, $19 billion in loans, and $36 billion in deposits. These numbers show that the Texas Banking Department supervises almost one-half of the total number of banks in the state although they hold only one-fourth of the aggregate dollar volumes of assets, loans and deposits. Moreover, the Department supervises 350 trust companies and trust departments of commercial banks. These hold $20.3 billion in fiduciary accounts and their activities range from traditional trust services to the fringes of banking.

Mr. Chairman, I am honored to have received your invitation to offer testimony on the condition of the commercial banking industry. Although some of my comments will be general in nature and applicable to the condition of the financial services industry nationally, I will primarily address commercial banking in Texas.

You have asked that I address seven specific questions. In order to properly and adequately respond, my written comments will follow the outline below.

I. Texas Banking: Today and Yesterday
II. Breakdown of the System
III. Focus on Management and Leading Indicators
IV. Responses to the Committee's Seven Questions
V. Conclusion

President Bush, this Committee, and its counterpart Committee in the House of Representatives, the banking industry collectively and as individuals, plus various regulatory agencies have recently combined forces to devise a solution for our nation's thrift crisis. Already debates are arising as to whether that legislation will be sufficient to prevent another such debacle or if the matter will need revisiting in a few years. Whatever the solution and whatever its adequacy, we must, in my opinion, assure that the nation's financial resources are properly managed and supervised. All possible solutions must be considered both for the short term and the long. I am especially appreciative and honored, therefore, for this opportunity to offer my testimony as Banking Commissioner of Texas.

I. TEXAS BANKING: TODAY AND YESTERDAY

Virtually any analysis of today's banking industry must begin with two questions, namely: "Where is the banking industry today?" and, "Where did it evolve from?" Responses to these questions form the basis for answering the more critical questions "What went wrong and how can we prevent a recurrence?".

A brief quote from an article entitled "Bank Failures" in the Fall 1988 Issues in Bank Regulation magazine succinctly capsulized the severity of the financial industry dilemma of today.

> "In the 1980s, more banks have failed than in the entire previous post-Depression period. These failures have coincided with a period of serious decline in certain sectors, notably agriculture, oil and gas, and commercial real estate."

One region, the Southwest, and one state, Texas, have received the lion's share of media coverage when it comes to problems in the banking industry. Texas, the Lone Star State, stands apart from all others in many respects and certainly in the number of bank failures.

Tables I and II show the rapid increase in bank failures during the decade of the 80s. In the 37-year period prior to 1980, only 212 banks failed. In little more than 37 months since, more than four times as many banks have failed or required federal assistance to avoid closure.

The failure rate has grown almost geometrically, and similarly, the Texas proportion of total U.S. bank failures has increased dramatically. Bank failure statistics no longer are the front page news they once were; in fact, sometimes they seem to be "no news" at all. In this case, however, "no news" is certainly not "good news".

Table I
Bank Failures -- U.S.
1943 - 1989

Year(s)	# of Failures*
1943 - 1979	212
1980	10
1981	10
1982	42
1983	48
1984	79
1985	120
1986	145
1987	203
1988	221
1989**	162

* Includes banks provided assistance to avoid failure:
1985 - 1; 1986 - 6; 1987 - 19; 1988 - 21; 1989 - 0.
** Total as of September 30, 1989
Source: FDIC

Table II
Bank Failures -- Texas and United States
1980 - 1989

Year	State Banks	National Banks	Texas Total	U.S. Total	Texas as % of U.S. Total
1980	0	0	0	10	0
1981	0	0	0	10	0
1982	4	3	7	42	17
1983	1	2	3	48	6
1984	2	4	6	79	8
1985	5	7	12	120	10
1986	14	12	26	145	18
1987	22	28	50	203	25
1988	43	70	113	221	51
1989*	41	72	113	162	70

*Totals as of September 30, 1989
Source: FDIC and Department of Banking

Chart A - Distribution of Failed/Assisted Banks

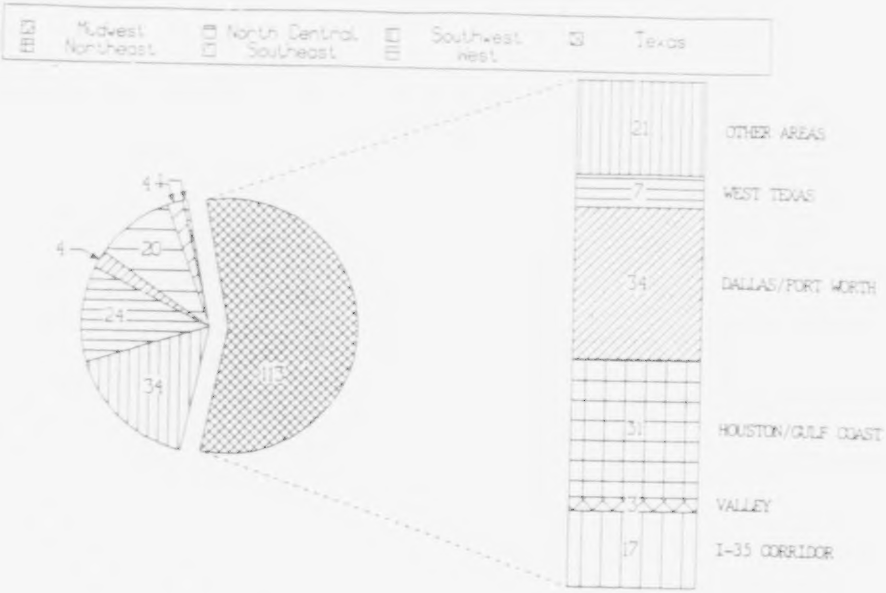


Chart A above illustrates the relative severity of the failed bank problem here in Texas and the Southwest. Slightly more than two-thirds of all bank failures in the United States during 1988 occurred in the Southwest. A little over one-half of all U.S. bank failures for the year happened in Texas.

Another indicator of the depth of the banking industry dilemma is the number of banks on the FDIC's "problem bank" list. ("Problem" banks are those rated 4 or 5 on the CAMEL rating system used by most bank regulatory agencies. CAMEL is an acronym used by regulators for rating the five primary aspects of bank condition. The letters stand for capital, assets, management, earnings and liquidity. Each component is rated on a scale of 1 to 5, 1 being strong and 5 being wholly unacceptable.) Table III below shows the increase in the raw number and is a percentage for banks considered problem institutions across the nation.

Table III
FDIC Problem Banks
1983 - 1989

Year-end	# of Problem Banks	% of Total Insured Banks
1983	642	4.4
1984	848	5.7
1985	1140	7.6
1986	1484	10.0
1987	1575	11.0
1988	1394	10.6
1989*	1271	9.8

*As of June 30, 1989
Source: FDIC

The 1987 Annual Report of the FDIC states, "After reaching an historical high of 1,624 in mid-1987, the number of FDIC-insured problem banks declined through the latter half of the year due to both record failures (in the Southwest) and improvements in the Midwest."

Table IV
Problem and Potential Problem Banks
State-chartered Banks in Texas

Date	Total # State Banks	3-rated Potential Problems	4 & 5-rated Problem Banks
6-30-87	886	158 - 18%	160 - 18%
12-31-87	833	174 - 21%	170 - 20%
6-30-88	764	154 - 20%	184 - 24%
12-31-88	714	159 - 22%	187 - 27%
6-30-89	657	158 - 24%	170 - 26%
9-30-89	646	152 - 24%	167 - 26%

Source: Department of Banking

Table IV provides a more detailed glimpse of the numbers of problem and "potential problem" (i.e. 3-rated) for Texas' state-chartered banks. In contrast to the FDIC's numbers which showed a nationwide peak for problem banks in mid-1987, the number of problem banks on the Texas Banking Department's list didn't peak until the fourth quarter of 1988. This is a reflection of the depth of economic problems in Texas and the "lag" effect of when economic problems show up as problem banks. (Exhibit I at the end of this testimony provides historical trends data on the ratings of state chartered banks.)

Another good indicator of "where we are" and "where we have come from" is the volume of losses --- losses in number of banks, total dollars of assets, total net worth, and total earnings.

Table V
Losses in Numbers, Assets & Earnings
State & National Banks in Texas
(B= billions; M=millions)

Year	# of Banks	Total Assets	Total Deposits	Total Capital & Reserves	Total Earnings
1985	1,936	$ 209B	$ 168B	$ 15.7B	$ 1,026M
1986	1,973	208B	165B	15.3B	(1,008M)
1987	1,772	190B	151B	13.7B	(2,545M)
1988	1,504	171B	143B	11.2B	(1,963M)
1989*	1,414	168B	138B	10.5B	(78M)

* Totals as of June 30, 1989
Source: FDIC
Note: 1989 data includes 4 "collecting" or "bridge" banks which hold $14 billion in assets, $9 billion in deposits, and $0.3 billion of equity capital. Earnings for the four collecting banks for the first six months of 1989 were $6 million.

A quick review of Table V shows the relative decline of commercial banking in Texas from 1985 to the present. Assets have dropped by almost 20% from the year-end 1985 level while total capital and reserves have decreased a full third. Net losses for the last three and one-half years total $5.6 billion, slightly more than one-third of the combined capital and reserves Texas banks started with on January 1st, 1986. (Refer to Exhibit II for June 30, 1988 and 1989 comparative financial data in Texas banks.)

The financial services industry for commercial banks in Texas has clearly suffered since the halcyon days of the late 1970s and early 1980s. Something went askew; something internal or external or some combination of both affected the system in a radical way. What happened? Why did it happen? These are issues addressed in the next section.

II. BREAKDOWN OF THE SYSTEM

In the first section data was presented to illustrate the current status of Texas banking and also earlier in the 1980s. The picture was one of today and yesterday; it was far from rosy. At least now, however, the numbers appear to be improving. Light can be seen at the end of the tunnel.

Today we know where we are and we also know what the road was like that brought us to this point. The question now is: "What event or combination of events occurred to cause one of the most robust economies in the nation to go from the center of a multi-lane expressway to the bottom of a deep, muddy ditch?"

In my opinion, three areas are deserving of more in-depth discussion. First, there are the commonly cited reasons for the bank failure. A short laundry list is offered for your consideration. Second is the failure of various control systems. And third concerns the traditional regulatory focus for examining and supervising banks.

Each of these areas point the finger of blame at something or someone. No single factor, however, deserves all the credit -- or discredit -- for the banking debacle. As Will Rogers might have said, "Ain't no call to crowd. There's plenty of blame to go 'round." What is important is not fixing blame, but rather learning from past mistakes. It is in this spirit of learning that I offer these comments on specific system weaknesses or breakdowns.

Commonly Cited Reasons

Various studies and analyses conducted by regulatory agencies, consulting firms, and industry pundits have produced what appears to be the last word for the bank failure disaster of the 80s. Each of the reasons offered is usually supported by convincing arguments. Virtually all reasons are valid -- to a degree -- and virtually all reasons contributed -- in part -- to the problem. Some factors are very important; others are not. All, however, have contributed to the problem.

A short list of the more commonly cited reasons follows:

- deregulation and new competitive freedoms
- economic instability
- excessive industry leveraging
- fraud and insider abuse
- excessive lending concentrations in energy and real estate
- mismanagement

Without spending a great deal of time rehashing old stories, a few summary comments on each are worth noting.

Deregulation and new competitive freedoms. The phase-out of Regulation Q mandated by the Depository Institutions Deregulation and Monetary Control Act of 1980, effectively removed the safety net on the liability side of the balance sheet. Banks and thrifts had to pay whatever market rate was necessary to attract deposits and were forced to pay much closer attention to managing spreads and matching sources and use of funds. Some did very well; others did not. The combination of an external factor with an internal deficiency, i.e. inadequate expertise in asset-liability management, resulted in an adverse impact on many Texas banks.

At the same time deregulation was occurring, financial institutions and nonbank banks were being allowed to compete in new ways and with greater freedom. Thrifts were permitted to engage in activities traditionally reserved for commercial banks. Nonbank banks such as American Express, Merrill Lynch, and Sears were invading the realm of financial service providers.

Aside from external competition, banks vied with one another for increasingly greater shares of the pie. Branch banking rules were expanded to permit more branches in an ever-increasing geographic circle. In unit banking states such as Texas or Iowa where branching laws restricted wide spread geographic expansion, use of the multi-bank holding company structure accomplished virtually the same result as state wide branching in California or Virginia but in an inefficient way. Interstate banking in many states opened up markets traditionally closed to the brightest and best banking organizations in the United States. Also, the easy entry, free-chartering practices of chartering authorities seemed to encourage start ups of new banks. In Texas alone, the number of individual bank charters grew from 1,336 in 1975 to 1,936 in 1985, a 45% increase.

Deregulation and new competitive freedoms – perhaps a case of too much, too soon – in any event, both were contributory factors which put pressure on the bottom lines of banks.

Economic instability. Throughout most of the 1970s and into the early 1980s, the national economy and especially the Southwestern economy were on a roll. Profits and growth were commonplace. All cylinders of the economic engine were firing in synch. Aggressive loan growth fueled economic expansion, and one begat the other.

In the energy cell, world oil prices soared from $3 bbl. in 1971 to $35 bbl. in 1981. The *value* of daily oil production in Texas tripled from $10 million in 1978 to $33 million in 1981. Over the same period, however, the *volume* of oil production actually declined. The oil boom spurred economic growth and simultaneously set the stage for an economic bust.

Real estate building and lending activity was a by-product of the energy-catalyzed expansion in the Southwest. By 1987, Texas banks had increased the percentage of real estate loans in their portfolios to 40%, well above the 23% level of 1982. While commercial real estate-based loans comprised two-thirds of all real estate loans at Texas Banks, they represented only one-half at other U.S. banks. Today, nonperforming real estate loans and other real estate held by banks equals roughly three-fourths of all nonperforming assets in Texas.

The rise of national interest rates, excessive levels of corporate debt, and associated interest costs produced economic volatility and instability in the late 1970s despite generally upbeat business conditions. In time, and most notably in the Southwest where an economic depression subsequently occurred, this instability affected the banking system. Like deregulation and competitive freedoms, economic instability was a contributing factor to record numbers of bank failures.

Excessive industry leveraging. Deregulation and greater competitive freedoms fostered a significant rise in the number of banks and bank branches. In Texas, a unit banking state, only very limited branching was permitted. In order to achieve a wider geographic presence, banking organizations were compelled to charter de novo banks in desired new markets.

Establishment of de novo banks and adding new branches requires capital. Capital is needed for financial growth and for more tangible assets such as brick and mortar. The latter may require more new capital, but in either case, capital is necessary to support expansion.

Much of this expansion was funded with borrowed money. Bank holding companies and individuals borrowed to charter brand new banks. Stockholders borrowed to further expand or recapitalize existing banks. The banking industry, already a highly leveraged business, was becoming more highly leveraged by using borrowed funds to support net worth. Leveraging was the modus operandi to bigger and more profitable banking organizations.

The downside to being too heavily leveraged is an inability to achieve projections upon which repayment of borrowed funds are based. Loans, including bank stock loans, have a maturity date and require repayment. At inception the projections and assumptions used to acquire loans undoubtedly looked reasonable and attainable. However, dramatic changes in economic conditions, competitive factors, interest rate, and other factors, caused many good projections to become unwanted potions.

Excessive leveraging undoubtedly contributed to the proliferation of banks and bank expansion. But when the time came to repay the bank stock loans and funds were unavailable, then either the borrowing bank suffered due to excessive dividend payouts which created a capital deficiency or the lending bank suffered from a nonperforming stock loan. While bank stock loans may not have been the single factor causing the failure of larger correspondent banks, losses on bank stock loans certainly contributed to the failure statistics.

Excessive concentrations in energy and real estate. As mentioned earlier under the Economic Instability section, the heavy use of credit in financing energy and real estate projects became disproportionately large relative to that which could be supported or repaid from normal operations. Oil and gas loans were predicated not only on unproven reserves but also on expectations of higher commodity prices and sustained values for drilling rigs and extraction equipment. A concentration existed and was being held aloft by tenuous supports.

Repayment of commercial real estate loans was similarly dependent upon imprudent expectations. It was assumed that properties being built and even those still on the drawing boards, many of which were speculative, would be absorbed by the market. Assumptions were also made that rental rates would remain strong and property values would continue to escalate or at least remain stable.

Of course no one has a crystal ball which enables them to predict the future. Many of the lending decisions made were done so with available information, using conventional lending philosophies and techniques which seemed to be working. In too many instances, however, repayment plans and cash flow projections were based on unrealistic appraisals. Too often, it seemed, appraisals could be obtained to support whatever value was desired. "MAI" became an acronym for "Made As Instructed" rather than representative of a professional industry whose judgements could be relied upon.

It should also be noted that Congressional changes in tax laws in the early 1980s helped to create an oversupply of commercial real estate. Subsequent reduction of income tax rates and elimination of deductibility for nonresidential mortgage interest largely curtailed the desirability of owning commercial real estate. As a result, price escalation reversed and the repayment capabilities of many borrowers fell short of debt-servicing requirements.

Fraud and insider abuse. The bank failure study conducted by the Comptroller of the Currency found that insider abuse was a significant factor in 35% of the failed banks. The study also found that material fraud played a significant role in 11% of the failures. "Problems of insider abuse and fraud were often related to the lack of oversight and controls." the study stated.

Insider abuse generally encompasses both the commission and omission of acts by insiders which in some way works to the detriment of the bank. Inherent in insider abuse is the fact that the insider somehow benefits because of his/her position. Fraud, on the other hand, relates to an intent to deceive or conceal. The two activities are often found hand-in-hand and often involve conflicts of interest or misplacement of the fiduciary trust which bankers hold.

It goes almost without saying that insider abuse and fraud have contributed to the bank failure dilemma. Detecting and stopping these types of activity can be difficult and is oftentimes accomplished only after the damage is done. That is why it is important to focus on internal control systems and external audit functions to assure that an environment permissive of this type of activity does not exist.

Mismanagement. The Comptroller's bank failure study concluded that a significant majority of failed national banks had serious managerial deficiencies contributing to their demise. Management, not just the chief executive officer or the top officers or the board, but the entire management system of a bank, must function properly for the bank or for any organization to survive and prosper. In the final analysis, all banks prosper or fail as a result of management decisions.

It would be far too easy to place all the blame on bank management -- or more correctly, mismanagement -- for causing the myriad Texas bank failures. That would be inaccurately and disproportionately affixing blame because it de-emphasizes too much the impact of external factors.

Despite the Southwest's regionally concentrated banking problems and failures, it cannot be validly assumed that Texas banks have been more inappropriately or incompetently managed than have banks in other region of the country.

For example, national banks are regulated and examined in the same manner across the nation, and banking practices, policies and procedures, i.e. management, are a major focus of bank regulation. Still, national bank failures have exceeded state bank failures in Texas. Can we assume that the OCC has been less effective or diligent in regulating and supervising banks in the Southwest than in other regions of the country? I think not.

While it is true that many bankers were caught up in the rapid growth, go-go years of the late 70s and early 80s and prudent banking practices may have been relaxed, external factors such as deregulation, competition, economic instability, and legal and regulatory aspects also played significant roles. Moreover, the longer these adverse external factors affect banks, the more critical the situation becomes. Given the debilitating forces of these external factors, ill-timed or imprudent management decisions and errors of judgement are amplified greatly and have a much more severe impact on bank profitability and survivability. (Additional insight in this regard is provided in an article by John R. Segerstrom. See Appendix A.)

Four Regulatory System Failures

Having looked at a brief list of failure factors, let me comment on what I feel were breakdowns in control systems which provide discipline to the banking industry. Four such control systems are: market controls, accounting controls, Congressional oversight, and state and federal regulatory controls.

Market controls. Market controls are the disciplines which the investing, depositing, and borrowing public place on a bank. Investors require an acceptable rate of return on their funds and they also desire preservation and appreciation of principal. If an investor analyzes the financial condition of a bank by scrutinizing balance sheet and income statement data, reading available market analyses, and assessing the quality of management, and then arrives at a conclusion that buying bank stock is not the most prudent of available investment options, he will choose to invest his money elsewhere. In order to attract new capital, therefore, it becomes necessary for bank managers to operate their institutions in a safe, sound manner which instills confidence in the minds of investors.

How did the market control system fail? Investors became enamored with banks stocks, particularly of smaller community banks, and failed to adequately analyze available data. Prestige, and perhaps greed, i.e., emotional factors, dominated in their investment decisions rather than objective analyses of numbers and operating methods. As a result, the discipline of market controls failed to prod bank managers to adhere to prudent banking tenets and also allowed capital to be too freely available. In fact, Texas' regional banks were the darlings of Wall Street and were prominently paraded as models for high performance banking.

Accounting controls. Accounting controls are the system of methods and rules for presenting financial data. Generally accepted accounting principles, or GAAP as they are more commonly known, comprise the primary system of accounting controls. In addition, there are regulatory accounting principles (RAP) which differ only slightly from GAAP. RAP usually are more conservative and are based more on safety and soundness considerations rather than strictly fairness and full disclosure.

An example of what may be considered a failure of the accounting control system relates to opinion audits. All major multi-bank holding companies such as First RepublicBank of Texas, MCorp., First City and Texas American Bancshares, and plus a substantial majority of smaller holding companies have annual audits by Big Eight accounting firms. Prior to bank problems becoming well known publicly, virtually every banking organization received an unqualified opinion. No issues of adverse significance or materiality were raised by auditors until the problems were firmly entrenched and the cancerous disease was pervasive. In some instances, a qualified opinion was rendered only after application had been made for federal bailout assistance.

At issue here is whether unqualified audit opinions truly present the condition of a banking entity. On a purely quantitative basis, the financial statements may have been accurate; but what about on a quantitative basis? If the loan loss reserve account was seriously understated, i.e., a qualitative value judgement, the balance sheet would portray a much greater value for assets and capital would appear stronger. A festering problem would thus be allowed to worsen and the ultimate resolution cost would rise.

In all fairness to accounting firms, auditing is not examining, and the analyses performed by auditors are not the same as those performed by examiners. Auditing in the past tended to focus on historical trends, industry loan loss ratios, and so forth while examining focused more on analyses of individual loan quality and collectibility. By using the latter approach, bank examiners frequently arrived at a much larger dollar amount for the reserve account. The end result? Publicly disclosed auditors' reports portrayed a stronger financial condition than did confidential examination reports.

Congressional oversight. The Banking industry is influenced also by the actions of Congress. Sometimes the results of that influence are immediate and direct; other times they are more indirect and take years to be fully realized. Deregulation and other actions of Congress at that time are examples for which there was a profound impact on banking and thrift operations.

Deregulation represented a radical and rapid change in the business of banking. In hindsight, it now appears that thrifts were given too much leeway and too many new powers when thrift managers lacked the necessary expertise and skills to operate in a deregulated environment. The situation was analogous to giving a highly responsive, powerful sportscar to a relatively inexperienced driver. The ability and temptation to engage in risky activities having significant consequences was a clear and present danger -- a danger some financial institutions did not avoid. Deregulating the thrift industry was the functional equivalent of issuing bank charters to existing financial institutions which were already undercapitalized and in financial distress.

Associated with deregulation were Congressional actions which effectively restricted bank regulatory agencies to pre-deregulation staffing and budget levels. As a result, additional examiners could not be hired to cope with growing regulatory responsibilities and more importantly, experienced examiners could not be retained because the agencies could no longer compete with the compensation packages being offered in the private sector.

Timing is usually critical to success. Congressional timing vis-a-vis supervisory agencies appears, in retrospect, to have been opposite to that which was needed. The activities of a deregulated financial industry required closer monitoring; to do so required greater numbers of experienced examiners. Instead, most regulatory agencies operated with fewer. The control system of Congressional oversight had not adequately provided for regulating the environment it created.

State and federal regulatory controls. Supervisory and examination techniques used by all regulatory agencies provide a control system. This control system failure is perhaps of most concern to me because it is a factor which I can directly influence. The question can and should be asked, "Where were the regulators when this problem was developing?" and "What actions did they take?"

During the good times of the late 1970s and early 1980s regulatory agencies such as the Texas Department of Banking were unable to retain an adequate staff of experienced examiners. Later, when tough times hit, we were unable to adequately address our regulatory responsibilities. We didn't have enough field examiners and those we did have had insufficient experience to deal with the problems. Make no mistake about it, our examiners did an exemplary job; but the Department was working with a company of new recruits when a battalion of experienced soldiers was required.

Other examples of inadequate or ill-timed regulation include the free-entry chartering mentality already discussed, the tendency of examiners, also, to get caught up in the go-go, sustained-growth banking environment, and the inability to react in a timely manner to changing due to budgetary or legislative restrictions.

State and federal regulatory control systems failed, in part, because of a misdirected approach to supervision. Nowadays, after much carnage has transpired, we are changing our methods to work smarter, not just harder, to anticipate, not just react. A full discussion of regulatory changes being implemented by the Texas Department of Banking is provided in Section III.

III. FOCUS ON MANAGEMENT AND LEADING INDICATORS

Up to this point, my testimony has focused on the "what" and "why" of the banking industry's problems. I have done so to develop necessary background information for responding to the Committee's seven specific questions. One more issue, namely, the focus on management, deserves further comment. This is especially needful since the supervisory process is evolving and adapting to a changing industry.

Misdirected Focus

Bank examiners and regulatory agencies have been likened to traffic cops -- they arrive at the scene of an accident after it has happened and attend to the dead and injured. But what good is served by telling the driver of a car which is in the ditch that there was a curve in the road and the road was slippery? Would it not be more appropriate to inform the driver two miles before of the upcoming road conditions?

How does this analogy illustrate the reality of the bank supervision and regulation? Examination techniques and enforcement tools used were often inappropriate or insufficient. Bank examination has traditionally been an asset quality evaluative process. By assessing the quality of individual assets, an inference was drawn as to the quality of management. We focused too much on *problem loans* – on the *result* of poor management policies, practices and decisions which were made two and three years prior. An "if-then" mentality prevailed -- if asset quality, earnings and capital were poor, then management was poor. Conversely, if assets, earnings and capital were strong, then management was strong. Sometimes that logic worked; often it did not. In short, examiners looked primarily at trailing indicators. What was needed was an examination technique that evaluated the policies and techniques by which management produced results.

Even when we were able to accurately identify the causes of a given undesirable bank condition, too often we lacked the necessary enforcement tools to effectively deal with the situation. We were not able to swiftly and surely put a stop to unacceptable management practices until clearly unacceptable results had been demonstrated. As long as the results appeared favorable, too much leeway was given for bank managers to engage in unsafe and unsound banking practices. In other words, the end justified the means. The flaw in that thinking, however, was that an inflationary economy was masking and glossing over the reality of poor management practices. We only saw the tip of the iceberg; the real danger lay beneath the surface and was only exposed when the inflationary tide receded. Using harsh enforcement actions after the damage had largely been done was ineffective regulation. We may have been doing things very well, but by concentrating on doing things *right* rather than doing the right *things*, we were very efficient but ineffective.

Trailing indicators. Trailing indicators tell a story after events have happened. Twisted rails and torn up track beds are trailing indicators of a train wreck. In banking, past due and nonperforming loan ratios, low capital and poor earnings, and strained liquidity are trailing indicators. They appear after a bank's problems become pronounced.

Past due and nonperforming ratios increase only after loan customers experience difficulty in repaying. The resultant adverse ratios reflect lending decisions made two to three years beforehand. Earnings tend to decline after borrowers default, causing the bank to suffer losses and replenish reserves. Capital ultimately is eroded by operating losses. All of these circumstances are after-the-fact, after the accident has occurred.

In assigning ratings, regulators have traditionally used the empirical numbers of trailing indicators. The "ends" of a CAMEL rating ---- C, A, E and L ---- were easily assigned because they were derived from comparative numbers or ratios. For example, suppose a bank's primary capital ratio after adjusting for losses identified during an examination was 5.3%. Part 325 of the FDIC's Rules and Regulations requires a minimum of 5.5% primary capital for "sound, well-run" banks. Since the bank under examination had less than the stipulated minimum, a component rating of "3" would likely be assigned for capital. If, on the other hand, the resulting ratio was 8.3%, a rating of "1" would probably be assigned.

Similar logic was used in rating asset quality(A), earnings(E), and liquidity(L). In fact, some agencies provided examiners with comparative ranges for assigning component ratings. The effect was a formula approach which oftentimes eliminated thoughtful examiner analysis and judgement.

After assigning ratings to C, A, E and L, a composite or overall rating would then be assigned and from that, a conclusion was drawn as to the quality of management. "M" was predicated on the condition of the other four components. If the car was in the ditch, then it was concluded that the driver must have been driving recklessly.

Redirected Focus

The Texas Department of Banking seeks to assist financial institutions to lead healthier, more fiscally fit lifestyles. The activities a bank chooses to engage in are the decisions of a bank's board and management. As a regulator, my purpose is to help bankers manage the associated risks and control the overall potential for risk to the banking system.

Leading Indicators. Today's examination techniques are evolving to focus more on leading indicators. Leading indicators reflect discretionary management decisions rather than the trailing results. Leading indicators set the stage for the resultant trailing indicators.

Examples of leading indicators are growth rates for assets, loans and deposits, dramatic changes in portfolio composition or strategic marketing objectives (i.e. retail vs. wholesale, consumer lending vs. corporate lending, etc.), or changes in people, policies or procedures. These types of change are often precursors to problems in capital adequacy, asset quality, earnings and liquidity.

To illustrate, consider the case of a bank which decides to shift its strategic focus from a relatively conservative, community-oriented bank serving the needs of local businesses and consumers to one that aggressively pursues commercial, corporate customers. On the asset side of the balance sheet, the loan portfolio mix will shift from numerous smaller dollar amount loans to larger and comparably fewer loans. Credit administration will also shift from a basic formula approach of collateralized, amortized lending to more sophisticated, financial analysis, cash flow and close monitoring practices.

On the liability side of the balance sheet, funding will likely gravitate away from relatively stable core deposits and toward more volatile, rate-sensitive deposits such as jumbo CDs and perhaps even brokered deposits. The need to maintain those deposits will often lead to higher rates on deposits. Also, the more competitive corporate lending environment generally will lead to a lower average yield on loans.

In banking, the difference between sales price and the cost of goods sold is called the net interest margin. It is the difference between the rate received on money lent and the rate paid for deposits. Wholesale banking and corporate lending generally entail a smaller net interest margin. Depending on the level of expertise and prudence exercised as a bank shifts its focus, the leading indicators of growth in loans, deposits and later for income accrued may foretell potential future problems in credit quality. These will be evidenced by trailing indicators. Examples of how we are adapting our supervisory and regulatory methods are discussed below.

Flexible examination procedures. The bank examination process has historically followed a set methodology regardless of the nature of the institution under review. Large or small, retail or wholesale, heavily loaned up or basically a bond bank, examination techniques changed very little.

Partially to compensate for scarce personnel resources but more so to concentrate on important areas, we at the Texas Banking Department and also other regulatory agencies have adopted flexible examination procedures. If asset quality has in the past been free of material problems but if available call report data indicates potential problems in earnings, examination procedures are being modified by examiners in charge to spend more time analyzing earnings. Or perhaps a management change has occurred in a historically clean, well-run bank. In that case, examiners may focus primarily on the policies of new management and on current underwriting practices.

In banks where specific problems have previously been identified, subsequent examinations may concentrate on management's efforts toward effecting improvement. Essentially, the examination process is being tailored to fit the unique circumstances encountered. The result? Anticipatory regulation and increased productivity. (Statistics in support of this are provided as Exhibits III through V.)

Portfolio Management and Quarterly Monitoring. Loan officers typically have a portfolio of customers with whom they deal one-on-one. This technique enables more timely and informed monitoring of the borrower's condition and repayment capacity. We are utilizing a similar approach in monitoring our banks.

The Comptroller of the Currency originated the portfolio management concept. Groups of 15 to 20 banks are assigned to an experienced senior examiner. Copies of quarterly call reports, problem loan watch lists, correspondence and other data about the ongoing conditions of the banks are continuously reviewed for adverse trends, significant changes, or other "leading indicators" which may be red flags of impending problems. If questions or a level of discomfort arises, the bank is contacted by phone, letter or in person to investigate the situation.

A strategy is then developed for dealing with each situation while it is still in the manageable, embryonic stage. Also, in cases of potential systemic problems, information is disseminated to all banks to help them avoid unwise decisions and to control an undesirable practice from becoming a wide spread problem. Prevention, not just cure, anticipation, not just reaction, is the essence of the portfolio management/quarterly monitoring technique. Portfolio management will improve our ability to monitor banks and the banking industry and to follow up on identified problem areas.

Management evaluation guidelines. All throughout this testimony runs the common thread of management -- or rather the importance of management. Given the critical role that management plays in the health of any organization, it is also critical that we, as regulators, spend more time evaluating management's practices instead of merely concentrating on management's results.

In order to more thoroughly and objectively evaluate the quality of management, the Texas Banking Department has developed a comprehensive set of Management Evaluation Guidelines which focus on the policies, procedures, performance and future prospects of management. Five primary aspects of bank operations are evaluated. These are credit administration, investments, asset-liability/funds management, audit and operations, and planning and budgeting. For each area there is a series of questions which assist an examiner to more thoroughly evaluate the board's policies, senior management's procedures, the performance achieved over time, and the future prospects.

After responding to each of the individual questions, examiners are required to specifically identify the respective strengths and weaknesses for each area and indicate what management's plans are for correcting deficiencies. If no plans exist, the examiner offers suggestions for improvement. In this way, constructive criticism is offered to bankers and management.

Inadequate enforcement powers and resources. Inadequate enforcement powers were a stumbling block the Department of Banking faced at a time when the banking industry's problems were burgeoning. Working with the Texas Finance Commission, a comprehensive slate of legislative recommendations was prepared and presented to the 1989 session of the Texas Legislature. Significant and positive changes were made which enable the Department to more effectively achieve its regulatory objectives. (Refer to Appendix B for an analysis of recent legislative changes.)

Previously existing officer removal powers essentially gave imprudent or self-serving bank managers a "free-shot". The results of bad banking practices first had to be observed through trailing indicators; then the offending manager was notified that the activity was to cease. Unfortunately, in too many instances, the bulk of the damage had already been done. Legislative changes now allow quick and decisive action. Upon identification of harmful banking practices, the offending bank manager can be removed and the potentially detrimental activity immediately stopped before the damage threatens viability of the bank.

We have also worked with the Legislature to upgrade the compensation levels of examiners and increase the number of examiners. These changes make employment with the Department of Banking more of a career option rather than a short term or training venture leading to higher paying positions in the private sector, and the ability to retain more experienced, seasoned examiners has resulted in improved productivity and more effective regulation.

Communication. Finally, there is the issue of communication. Far too often we as regulator's identified symptoms and notified a bank's board and management of the bank's condition by means of a technical, statistically oriented examination report. Very little time was spent in discussion of the causes of problems and much time was spent preaching about the resulting condition.

We have now come to realize that by discussing the causes of problems and by shedding more light on the inherent risks of various banking activities, we can assist bankers to more effectively manage those risks and to avoid unwarranted risk. Examiners have been instructed to more fully discuss the condition and the cause of a bank's situation at meetings with boards of directors. At industry seminars and other non-examination opportunities, representatives of regulatory agencies are taking time to explain more about the regulatory process and the "hows" and "whys" of supervision and regulation. In so doing, we hope to achieve a better exchange of methods, concepts and philosophies. By exercising anticipatory techniques and open communication, we believe a healthier, more profitable financial industry can be achieved. We also hope to avoid mistakes of the past and the consequences now costing billions of dollars to correct.

IV. RESPONSES TO THE COMMITTEE'S SEVEN QUESTIONS

Question 1: Am I satisfied that the state-chartered commercial banks and savings banks that I oversee have enough capital to protect the public interest and avoid a future crisis at their insurance funds?

Response: My first thought after reading this question is: "How much is enough?" By definition, capital is the private sector cushion that precedes public assistance. Given the crisis from which Texas banking is now emerging, I am pleased to see the level of capital stabilizing and beginning to build. However, as a regulator, I would prefer a higher level of capital.

Question 2: Am I confident that earnings reported at these ~~institu~~tions reflect their true earnings performance?

Response: Assuming that unintentional errors in filling out federally mandated call reports of income and condition are insignificant, yes, I am confident that reported earnings reflect actual performance. However, when economic conditions become unstable, it is very difficult to be confident that the reserve for loan losses is adequate. Moreover, the reserve often has a significant impact on earnings.

Question 3: Do I have any concerns about the portfolio composition (particularly investments in real estate, LBOs and LDC lending) at these institutions?

Response: Institutions regulated by the Texas Banking Department have very limited exposure to LBOs and LDC lending. They do, however, have material amounts of real estate-based loans which is true of many financial institutions within Texas. Yes, I have concerns that some of these borrowers may have difficulty repaying their loans due to the depressed values of real estate and the excessive inventory. However, as long as a particular type of lending is done in a prudent manner and to a degree commensurate with a bank's expertise and capital support, I can develop a comfort level with that type of investment.

Question 4: Am I satisfied that state-chartered commercial banks and savings banks are being examined and supervised in an effective and timely fashion?

Response: Again, as in my response to Question #1, I must say yes and no. Yes, I am satisfied that banks under my supervision are being examined and supervised reasonably well in light of the crisis we have endured for the last four years. We have made significant strides in timeliness and effectiveness, but we still have room for improvement. We have initiated many new methods and programs to enhance our regulatory effectiveness, and I expect that within the next year we will be able to achieve fully our desired objectives. We are now down to an 18-month examination cycle for state banks (by either state or federal agency) and our goal is a one-year cycle.

Question 5: What is my record with regard to initiating, and accomplishing my goals for enforcement actions?

Response: First let me say that I have no specific numeric goals for various enforcement actions. My objective is that the action fit the circumstances as to content, strength, and timeliness. Has the Texas Banking Department been as effective as it would like in correcting bank problems through the use of administrative actions? No. Would enforcement actions necessarily have corrected the problems? No. Have the actions that we have initiated been effective in limiting the damage until a more permanent resolution could be implemented? Yes, I believe so. (Data indicating the level and nature of administrative/enforcement actions initiated by the Department are contained in Exhibits VI & VII.)

Question 6: What is my forecast of the condition of state-chartered banks and thrifts under my jurisdiction for the next year?

Response: Some areas of the state may experience continued difficulties as a result of the drag of depressed real estate values; but overall, I believe the Texas economy has begun to find solid footing and is poised for recovery. The timing and strength of that recovery is not yet clear and, since financial institutions tend to mirror economic activity, there will be a lag effect in the recovery of the condition of banks and thrifts. I anticipate that failures should peak in 1989 and begin to recede in 1990. We could experience another 150 - 200 state and national bank failures over the next three years as the weakest institutions are unable to recover.

Question 7: What plan of action do I have to remedy any deficiencies I perceive in Texas?

Response: My plan of action for correcting deficiencies is already being implemented and will be refined as circumstances change. Specifics of my plan are discussed in Part III, Focus on Management and Leading Indicators, under the subheading Redirected Focus. It includes flexible examination procedures, portfolio management/quarterly monitoring, comprehensive management evaluation guidelines, strengthened enforcement powers through close cooperation with the Finance Commission, and more communication with supervised entities. I am pleased to report that these initiatives are well underway and are assisting greatly in the evolution from reactive regulation to anticipatory regulation.

V. SUMMARY

The financial industry in Texas has traversed the gamut from high performance banking to highly publicized disaster. Like a theme park thrill ride, the industry has taken a fast-paced trip from the crest of a tall wave into a deep trough. That overused quote from Dickens about the "best of times and worst of times" seems all too fitting. Texas has amassed impressive statistics – on both ends of the spectrum.

Texas banking is not yet out of the woods. The number of failures for 1989 will set a new record. In the first nine months alone, Texas has posted as many failures as in all of 1988. Failures of major, multi-bank holding company organizations have obviously skewed the numbers; but even on an adjusted basis, the numbers are record book material.

In the aftermath, many have asked, "Why?" I submit, Mr. Chairman and members of the Committee, that the answer lies in several factors and in a breakdown of four control systems. My testimony includes a brief listing of the more commonly cited failure reasons. Some of the reasons are external in nature, others are internal; not the least of them is mismanagement. After all, in the final analysis, all failures can be related to the discretionary decisions of management.

In addition to recognizing the interrelationships of the various factors, it is necessary to appreciate the amplification effect which external factors have on internal management decisions. It is also very necessary that we recognize the importance of the results which can occur when regulatory control systems cease to be effective. By studying the factors and system failures which led to and fostered the financial industry crisis, we have now learned that our regulatory methodologies needed to change just to keep pace with a dynamic and highly competitive banking industry.

Traditionally, we as regulators had focused on trailing indicators and had identified symptoms of problems rather than leading indicators and the causes of problems. We regulated primarily by reaction rather than through anticipation. The flaw to this methodology was that our medicine was being applied well after the disease had incubated into a serious malady.

Methods of supervision and regulation are evolving to focus on banking practices which have the potential for producing unacceptable individual or systemic risks. The focus today is on management's policies and practices, not just on their performance. Policies and practices are usually the precursors of that which is to follow while performance may be the masked results of a buoyant economy.

We at the Texas Department of Banking have taken positive steps to redirect our supervisory techniques. Some of our initiatives in this regard include: flexible examination procedures designed to concentrate regulatory resources on banking aspects having the highest potential for risk; portfolio management and quarterly monitoring designed to enhance and expedite our identification and regulatory response to bank conditions; comprehensive management evaluation guidelines designed to more thoroughly and objectively assess the quality of management and management practices; strengthened enforcement powers designed to deal more effectively with onerous banking managers or practices; and last but far from least, a renewed emphasis on communication skills so that we can be more effective in achieving our regulatory objectives.

All of the above evolving techniques have the common thread of applying that ounce of prevention rather than the costly pound of cure. We are striving to convert the educational experiences of the past into more intelligent methods for the future. There will always be room for refinement and improvement, but there must never again be an environment which permits a repeat of history.

Mr. Chairman and members of the Committee, I am grateful for the opportunity to respond to your questions and offer my perspectives. Thank you.

Appendix A

NEWS OF INTEREST TO
STATE CHARTERED BANKS

the CSBS Supervisor

Vol. 24, No. [illegible] July-August 1987

STRESS MECHANICS: UNDERSTANDING HOW DEREGULATED INDEPENDENT BANKS WORK

by John R. Segerstrom

The effective measurement of risk is increasingly important to bankers and their regulators in today's deregulated environment. Our guest commentator, John Segerstrom, herein presents a fresh, challenging new approach to evaluating the continuum of bank management decisions and their impact on institutional safety and soundness. The concept of "Stress Mechanics" is a significant contribution to the dialogue on institutional risk management and safety and soundness regulation which deserves our serious consideration.

During the past three years, my associates and I have performed an automated risk analysis, using our intelligent software named ALIX, on hundreds of independent banks. We have noticed that the banks that are structured with very low net financial risk—according to ALIX—are also consistent high performers. We have only found a dozen or so such banks; they range from old to new, big to small, urban to rural, and unit-bank-state to branch-state locations. Within this diversity, these banks share two attributes: they came through deregulation without a hitch and have earned real money each year for the past ten years or so (or for as long as they have existed).

John R. Segerstrom

Obviously, we have analyzed other banks that were current high performers, but we found none that could demonstrate the consistent high performance of our low-risk sample. The vast majority of our test population has been comprised of average to mediocre performers with varying amounts of financial risk embedded in their structures. For the past six months or so, we have been looking for the relationship that appears to exist between good strategic risk management and high performance, and we think we have found it: we call it Stress Mechanics.

To illustrate the concept, we like to use the old homily about an unsuccessful military campaign:

> *For want of a nail, the shoe was lost; for want of a shoe, the horse was lost; for want of a horse, the trooper was lost; for want of a trooper the battle was lost; for want of a battle, the war was lost.*

Taken as a whole, this progression is so unlikely that no one takes it very seriously. The chances that a faulty horseshoe nail would change the outcome of a war are pretty remote. But the chances of a faulty nail causing higher casualties in a battle because of the missing trooper are *much* higher.

Similarly, in banking, the chances of a single mistake resulting in failure are remote. Bankers make mistakes all the time, and only about 1% of the nation's banks fail each year, a figure that is aggravated by special circumstances right now. But in our test population, between 80% and 90% of the banks were operating without a nail, or a horse, or a trooper and were suffering degraded performance as a result.

In Bank Stress Mechanics, each element (nail, horse, trooper, etc.) is called a *Stress Point*, and the progression linking them within an individual bank is called a *Stress Mechanism*. Stress points are further classified as primary (those that represent unforced management decisions), secondary (those that result from primary stress points), and tertiary (those that impair the risk *capacity* of the bank and thus endanger its existence). Although each bank situation is unique, some things can be said about the behavior of stress mechanisms in general, and a specific banking example will help illustrate by providing context.

Continued

Examplebank is structured to benefit from rising interest rates through increased margins (this condition is commonly referred to as asset sensitivity). Rates drop, profitability is eroded, and the erosion accelerates as liability rates —interest expenses—become less variable than asset rates. To offset this decline, the bank begins to extend portfolio maturities and take bond profits into income. To maintain a positive spread, and to offset progressively worse margins with bond gains, maturities are allowed to creep outward until the portfolio is quite long.

Suddenly, the rate trend reverses itself and the bonds fall into a loss position (knowing that accounting practices will allow the loss to be hidden from view in the books) in hopes the previous trend in rates will resume, but what if it doesn't? Liquidity is impaired; rate risk cannot be as effectively offset; and reported earnings plunge without bond gains to bolster them. The battle is lost.

Subsequent decisions will be made in an environment of intense pressure heightened by embarassment. They probably won't be the best decisions; they might be terrible. The outcome of the war is now in serious doubt, *and even the best decisions from this point will not restore the vitality of the bank for a long, long time*—until the stress mechanism works itself out.

> *For want of high rates, the earnings were lost; for want of earnings, the liquidity was lost; for want of liquidity . . .*

It is conventional theory that Examplebank's problems began with the purchase of long bonds for gain, but we disagree. The problems arose from the creation of an asset sensitive bank by management. This is the *primary stress point* in Examplebank. It is the true source of the subsequent stress mechanism.

Primary stress points share three characteristics:

1. Each represents an unforced management decision, a strategic error or oversight;
2. Each requires an activator from the environment, such as a change in interest rates or a new regulation. Until activated, primary stress points are effectively invisible in the records of the bank; and
3. Once activated, each primary stress point sets in motion a process—a Stress Mechanism—that requires years to reverse, and which impairs performance at all times during its existence.

We think there are only three primary stress points in independent banking: *asset sensitivity, high operating expenses relative to capital, and weak policy controls over secondary stress points.* The presence of any one or more of these in an independent bank, regardless of the bank's apparent financial health, represents a significant threat to the bank's future.

Secondary stress points are evidence of a management response to activation of a primary stress point. This is the birth of an *unstable stress mechanism* (if management does not respond, the typical result is a chronic condition of substandard performance —a *stable stress mechanism*). There are six secondary stress points, again a surprisingly small number:

1. Excessive market risk
2. Declining liquidity
3. Excessive liability sensitivity
4. Use of market-rate liabilities
5. Riskier individual loans
6. Accounting gymnastics

These secondary stress points often cause reported earnings to remain stable. The quality of those earnings, however, begins to drop immediately, but this is very difficult to measure at the time.

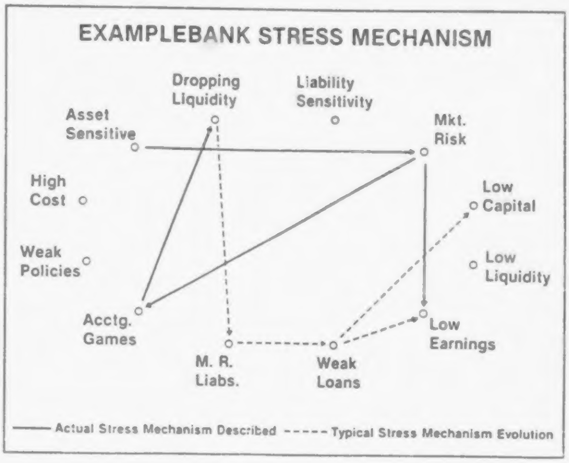
Tertiary stress points, those that threaten the existence of the bank when encountered, are the common measures of financial health:

1. Low capital
2. Low absolute earnings (as opposed to earnings vs. peer group)
3. Significant customer withdrawals
4. Significant loan defaults

These are encountered at the end of the development of an unstable stress mechanism. They may occur some years after the activation of a primary stress point. The future of a bank with one or more of these tertiary stress points is bleak.

Although there are a manageable few primary, secondary and tertiary stress points, the number of ways of assembling them into a stress mechanism is very large indeed. After the fact, we are able to "map" a particular stress mechanism in a bank (Examplebank's "map" is shown below), but spe-

Continued



cific predictions are impossible. The most important general statement that can be made is that once activated, a stress mechanism has no natural enemies within the bank and feeds on itself. We have noticed other consequential factors that emerge in almost all cases: management turnover, operational losses from weakened controls, fatigue and low morale, each of which makes the situation more difficult.

Failure is not a common consequence (although the banks evidencing tertiary stress points fail much more frequently). Merger is more likely, and recovery is the most common outcome of all. The natural instability of stress mechanisms is offset by intervention by the directors of the bank or by regulators. Intervention breaks the cycle of the mechanism and brings the quality of reported earnings into line with reality, highlighting the proper recovery course and defining the task of restoring the health of the bank. Usually, the war is won. But the casualty rate is dreadful, and unnecessary.

Consider the implications of our findings for industry performance potential. Over 80% of the banks we have analyzed had active stress mechanisms; of these, more than half were unstable. Since stress mechanisms degrade performance, the reported ROA of any peer group drawn from our test population must be well below par. We believe that stress point control by an ideal 100% of these banks would raise the average ROA by .5%, which is a huge number. Huge as it is, though, it is overshadowed by the implications of stress mechanics for regulation.

Stress mechanics suggests that regulators could watch the three primary stress points in each bank, noting the environmental activators that are germane to the bank's operations. When these activators happen, the affected banks would be placed on a watch list.

The regulation process would then focus on early detection of any secondary stress point, indicating the birth of an unstable stress mechanism. At the first such sign, strong intervention to break the cycle would be called for. Our findings suggest that immediate, strong action at the earliest possible time converts the process to one of recovery at the least cost to both the bank and the regulator.

To the extent that regulation is driven by the CAMEL rating, intervention will be inevitably late. Of the six critical secondary stress points, only one (Liquidity) is included in the CAMEL rating; the others would be missed. Intervention based on a stress mechanics approach would allow regulators to catch up to their constituents and minimize the cost of maintaining stability.

The diversity of our low risk banks suggests that stress mechanics regulation would not impair flexibility or innovation in the industry as it responds to the environment. Stress mechanics is very susceptible to automation and its resultant efficiencies; and it can be easily taught and implemented in the field, mitigating the cost and other adverse effects of employee turnover. Three western state regulatory agencies (two with unlimited branching, one with limited branching) are trying ALIX as a tool, and after two years of testing, we are excited by the results. Stress mechanics look like a better way to regulate deregulation.

(Mr. Segerstrom is Chairman of Segerstrom & Co., a bank consulting firm in Portland, Oregon.)

Appendix B

Texas Department of Banking

Ann Graham
General Counsel

Memorandum to: Department of Banking Personnel

From: Ann Graham, General Counsel

Subject: Analysis of Changes to the Texas Banking Code Enacted by the 71st Session of the Texas Legislature

An updated version of the Banking Code is currently being prepared and will be sent to you when it is ready. In the interim, this analysis of the changes to the Banking Code enacted by the Texas Legislature during the 71st session should prove helpful. If you have any questions regarding these changes, please contact the Legal Department.

IDENTIFICATION OF BANK FACILITIES (S.B. 1001)

The Banking Code has been amended to add a new Article 342-917 to provide that a bank may not use any form of advertising, including signs and printed forms (checks, cashier's checks, loan applications and certificates of deposit), that would lead a member of the public to conclude that a branch facility is a separately chartered bank. This statute applies to both state and national banks, and became effective on September 1, 1989.

Existing bank signage and documents must be brought into compliance by June 1, 1990. The Banking Commissioner may grant a six month extension for compliance upon a showing of hardship. New signs and bank documents must comply after September 1, 1989.

The rationale for this new statute is to protect members of the public, to make sure that as banks acquire branch locations they use the legal charter name and accurately identify to their customers and members of the public if they are doing business as a branch rather than a separately chartered bank which would have separate deposit insurance.

Practical Application: First State Bank acquires Anywhere State Bank and operates it as a branch location. Permissible identification of the Anywhere location includes:

1. First State Bank

   (No branch identifier is required for any location using only the legal charter name).

2. First State

   (A shortened form of the legal charter name is permitted at any location.)

Headquarters Office
2601 N. Lamar Boulevard, Austin, Texas 78705-4294 ■ (512) 479-1200
Regional Offices
2201 N. Collins, Suite 220, Arlington, Texas 76011-2615 ■ (817) 261-4773
4200 N. Lamar Boulevard, Suite 108, Austin, Texas 78756-3430 ■ (512) 459-1715
9525 Katy Freeway, Suite 142, Houston, Texas 77024-1413 ■ (713) 932-6146
4930 Loop 289 South, Suite 310A, Lubbock, Texas 79414-4701 ■ (806)792-0793

3. First State Bank
   Anywhere Branch

4. First State Bank
   Anywhere

   (The branch identifier does not have to use the word "Branch.")

5. First State Bank
   Anywhere Facility

   (Words such as "Location," "Office," etc. are also acceptable.)

Please write or call the Office of the General Counsel if other specific situations require interpretation.

CALL REPORTS (S.B. 962)

Texas Banking Code Article 342-211 has been amended to delete the prohibition against giving advance notice of the time when banks will be required pursuant to Article 342-209 to submit call reports (quarterly statements of income and condition). Since these reports are routinely prepared on a calendar quarter basis, the deleted provision served no purpose. The effective date of this amendment is June 16, 1989.

CHANGE OF DOMICILE (S.B. 962)

Banking Code Article 342-314 has been amended to permit a bank or trust company to use a simplified procedure to change its designated domicile from the existing main office to a previously established branch office by giving the Banking Commissioner prior written notice. All other applications for change of domicile continue to require State Banking Board approval. The effective date of this amendment is June 16, 1989.

DISQUALIFICATION OF A BANK DIRECTOR (S.B. 962)

Banking Code Article 342-405 has been amended to disqualify a bank director if the bank holds a charged off "obligation" against him. "Obligation" can include, for example, overdrafts and accrued interest, as well as guarantees and extensions of credit. All direct or indirect advances of funds to a person that are made on the basis of an obligation of the person to repay the funds or that are repayable from specific property pledged by or on behalf of the person would be included. Before this amendment, directors were disqualified for charged off "notes". The effective date of this amendment is June 16, 1989.

ENFORCEMENT POWERS (S.B. 962)

Banking Code Article 342-412 has been amended to strengthen the power to initiate administrative proceedings for removal of officers, directors and employees from state banks. This amendment is effective as of June 16, 1989. Grounds for removal now include:

1. Violations of banking laws or regulations.
2. Willful neglect of duties or breach of trust or fiduciary duties.
3. Committing any fraudulent or questionable practice in the conduct of the bank's business that endangers the bank's reputation or threatens its solvency.
4. Refusing to submit to examination under oath.
5. Conducting business in an unsafe or unauthorized manner.
6. Causing the bank to violate any conditions of its charter or any agreement with the Banking Commissioner or the Banking Department.
7. Violating a cease and desist order that has become final.
8. The new legislation adds the power to remove an officer, director or person "participating in the conduct of the affairs of a State bank" if the Banking Commissioner finds that director, officer, or person has, because of his personal dishonesty or willful or continuing disregard to another bank or business institution's safety and soundness, caused substantial financial loss or other damage to that other bank or business and has shown unfitness to continue his position at the State Bank.

Procedures for removal require the Commissioner to give a written Notice of Removal stating the grounds. Removal will be effective 10 days after the Notice of Removal unless the person appeals to the Finance Commission. The Banking Commissioner may make removal effective immediately if necessary to protect the bank or the interests of its depositors. This immediate removal or suspension will be effective during any appeal unless stayed by court order.

LOAN FEES (S.B. 962)

Banking Code Article 342-508 has been amended to allow loan origination fees on commercial loans. Loans made on or after June 16, 1989 (the effective date of S.B. 962) will be subject to the new law, while those made prior to this date will be governed by the law in effect when the loan was made.

Under the new law, banks are still severely restricted charging loan origination fees on consumer loans. Banks may charge consumer loan applicants for abstracts, attorney's opinions or title insurance policies, filing, recording or appraisal fees or other expenses necessary or proper for the protection of the lender and actually incurred. For consumer loans over $100 and for one month or more in duration, the bank may charge loan origination fees in an amount agreed upon, but not to exceed $15.

Note the distinction between permissible charges for the actually incurred expenses listed and impermissible loan origination fees for providing such services as preparing the loan documents and investigating creditworthiness. No loan origination fee (not even the $15) may be charged for extension or renewal of a consumer loan for which a charge has been previously imposed. Note also the stringent penalty for charging impermissible fees: **ALL INTEREST SHALL BE FORFEITED.** If there is any conflict between this provision and the Consumer Credit Code (Title 79 of Vernon's Civil Statutes), the Consumer Credit Code controls.

FINANCIAL INSTITUTIONS NOT REQUIRED TO POST SUPERSEDEAS BONDS (S.B.962)

The Banking Code has been amended to add a new article 342-609 providing that state and national banks and state and federal savings and loan associations are not required to post a supersedeas bond to stop the execution of a lien or attachment of bank assets pending an appeal of an adverse judgment. This section only applies to an attachment, injunction, or execution issued on or after September 1, 1989.

DISCLOSURE OF FINANCIAL INSTITUTION CUSTOMER RECORDS (S.B. 962)

Article 342-705 of the Banking Code has been amended to add the provision that financial institutions may be required to produce depositor and borrower records to third parties only where:

1. The customer is a party to a lawsuit involving the account records.
2. The financial institution is a party to a lawsuit and the customer consents in writing to production of his account records.
3. A legislative investigating committee of the Texas Legislature issues a subpoena for the records.
4. The Attorney General requests the records. The party seeking the records must pay copying costs in advance or post a bond for such costs.

This new provision, effective June 16, 1989, does not make the bank liable for disclosure required by federal law or use or disclosure by the bank of account information or records made in good faith in the usual course of the financial business of the bank, or voluntary use or disclosure by the bank in litigation against the bank. The new provision does not apply to the investigation or prosecution of criminal offenses.

CONSERVATORSHIP PROCEEDINGS (SB 962)

Banking Code Article 342-801a was amended to provide that a bank or trust company may be placed in conservatorship if on examination or other credible evidence, the Banking Commissioner finds that the bank or trust company is in an unsafe condition and immediate and irreparable harm is threatened to the bank, its depositors or stockholders or the public. Conservatorship is now available as an enforcement remedy directly, without requiring that the bank or trust company first be placed under supervision and fail to meet the terms of supervision. The effective date of this amendment is June 16, 1989.

STATUTE OF FRAUDS - LOAN AGREEMENTS MUST BE IN WRITING (S.B. 413)

The Business and Commerce Code was amended to add a new Section 26.02 providing that loan agreements over $50,000 are not enforceable unless the agreement is in writing and signed by the party to be bound. This amendment applies only to a loan agreement executed on or after September 1, 1989, the effective date of the Act.

This provision applies to state and national banks, state and federal savings and loan associations, credit unions, holding companies, subsidiaries or affiliates of the above named financial institutions and HUD lenders. "Loan agreement" is defined as a promise, promissory note, agreement, undertaking, security agreement, deed of trust, or other document or commitment pursuant to which a financial institution loans or delays repayment of or agrees to loan or delay repayment of money, goods, or other thing of value. Credit card and open-end accounts intended or used primarily for personal, family or household use are not covered.

Financial institutions are required to give borrowers notice of this provision. The statute provides that the notice must state substantially the following:

"This written loan agreement represents the final agreement between the parties and may not be contradicted by evidence of prior, contemporaneous, or subsequent oral agreements of the parties. There are no unwritten oral agreements between the parties."

The notice can be in a separate document or incorporated into one or more of the loan agreement documents. If the notice is not given, oral agreements will be permitted to vary or defeat the written loan agreement.

Financial institutions are required to conspicuously post notices that inform borrowers of this provision. The Finance Commission will meet October 20, 1989 to adopt the required language of the notice.

FINANCE COMMISSION REORGANIZATION (S.B. 607)

S.B. 607, effective September 1, 1989, provided that oversight for the Banking Department, the Savings and Loan Department and the Consumer Credit Department will be consolidated in a reorganized Finance Commission. The new Finance Commission will consist of nine members appointed by the Governor: five public representatives, two banking industry executives and two savings and loan industry executives. One of the public members must be a certified public accountant. The Finance Commission will meet at least six times a year.

Powers and duties of the Finance Commission are: to adopt rules and determine general policies for the regulation of state banks, state savings and loan associations, and the consumer credit industry in Texas; to consult and advise the Banking Commissioner, Savings and Loan Commissioner and Consumer Credit Commissioner on the implementation and enforcement of the rules and policies adopted by the Finance Commission; and to make a thorough study of the Texas banking, savings and loan and consumer credit statutes and report findings and recommendations every two years to the Legislature.

Appeals of certain orders of the Banking Commissioner (cease and desist order, order of removal, or order appointing a supervisor or conservator), which were formerly heard by the Banking Section will now be heard by the full Finance Commission, inasmuch as separate Sections of the Finance Commission for each of the three industries have been consolidated into the full Finance Commission for all purposes.

TRUST COMPANIES (S.B. 1072)

The effective date of S.B. 1072 is September 1, 1989. Under the Act, Article 342-1101, Section 2 has been amended to add a new subsection (b) which gives the Banking Section rulemaking authority to prescribe rules pursuant to which the Banking Commissioner may require capital in addition to the minimum of $500,000.00 as may be necessary to assure the safety and soundness of trust companies engaged in activities under subsection (a) which involve greater risk than traditional fiduciary activities.

Section 4 of this Article has been amended to make void the charter of any trust company which failed to present its original charter to the Department for substitution prior to May 26, 1988, unless the Commissioner accepted the former charter presented for substitution after May 26, 1988.

Article 342-1102 has been amended to clarify that Article 342-301 (relating to banking powers) and Article 342-411a (relating to securities exemptions) of the Code do not apply to trust companies. Article 342-1101 sets forth the authorized powers of trust companies, and Article 342-1107 requires that trust companies must comply with the State Securities Act. Although these two articles appear to fulfill the "unless otherwise provided" standard to exclude the applicability of Article 342-301 and 342-411a, these articles were specifically excluded to eliminate confusion on these issues.

Article 342-1103, Section 1 has been amended to change the deadline for filing annual reports from February 1 to March 1 of each year and to require trust companies to file and publish quarterly statements of financial condition in accordance with Article 342-209 of the Code. Subsection (b) was added to provide that the Commissioner may require trust companies to obtain an external CPA audit and provide the Commissioner a copy of the audit report.

Section 6 of Article 342-1103 regarding exemptions has been amended to delete the exemption for inactive companies. The exemption for trust companies not doing business with the general public is retained in the amended section.

Article 342-1105, Section (c) has been amended to clarify that an independent receiver of a trust company may be appointed only upon application by the Commissioner to a court of competent jurisdiction.

COMMERCIAL BANKS

Exhibit I

CONDITION SUMMARY (9-30-89)

STATUS

Camel Rating	Austin	DFW	Houston	W Texas	Total State
5	7% - 13	7% - 15	8% - 13	0% - 0	6% - 41
4	18% - 33	25% - 50	18% - 29	13% - 14	20% - 126
3	23% - 41	26% - 53	22% - 35	22% - 23	24% - 152
2	34% - 60	34% - 69	30% - 48	44% - 47	35% - 224
1	16% - 29	8% - 16	20% - 31	21% - 22	15% - 98
0	2% - 3	0% - 0	1% - 2	0% - 0	1% - 5
	179	203	158	106	646

TREND

Camel Rating	8/31/87		8/31/88		11/30/88 1		2/28/89 2		5/31/89 3		8/31/89 4	
	%	#	%	#	FY 89							
5	3%	23	6%	42	7%	48	7%	46	7%	44	6%	42
4	16%	141	19%	143	18%	133	18%	125	19%	130	20%	127
3	20%	172	21%	158	22%	162	24%	163	23%	152	24%	156
2	35%	310	36%	266	36%	257	34%	234	34%	225	33%	216
1	22%	197	17%	123	16%	113	16%	107	16%	107	16%	102
0	4%	37	1%	8	1%	6	1%	8	1%	7	1%	5
	100%	880	100%	740	100%	719	100%	683	100%	665	100%	648

PRELIMINARY DRAFT

Exhibit II

COMPARITIVE STATEMENT OF CONDITION FOR STATE AND NATIONAL BANKS YEAR-TO-DATE JUNE 30, 1989 AND JUNE 30,1988

	06/30/89				06/30/88	
	656	754	4	1,414	1,660	
ACCOUNT DESCRIPTION	STATE BANKS	NATIONAL BANKS	COLLECTING or BRIDGE BANKS	ALL BANKS	ALL BANKS	PERCENT CHANGE
ASSETS (In Millions)						
CASH & DUE FROM BANKS	3,641	12,620	698	16,959	18,853	-10.05%
INVESTMENT SECURITIES	12,130	26,399	1,932	40,461	32,510	24.46%
TOTAL LOANS AND LEASES	18,950	65,596	8,471	93,017	101,788	-8.62%
Less: LVR	462	1,778	0	2,240	4,723	-52.57%
NET LOANS & LEASES	18,488	63,818	8,471	90,777	97,065	-6.5%
FEDERAL FUNDS SOLD	3,369	11,026	1,034	15,429	20,157	-23.5%
OTHER REAL ESTATE	768	2,688	1,244	4,700	4,059	15.8%
PREMISES & EQUIPMENT (NET)	857	2,668	275	3,800	3,784	0.4%
INTANGIBLE ASSETS	19	46	0	65	354	-81.6%
OTHER ASSETS	778	8,404	391	9,573	4,873	96.4%
NONPERFORMING LOANS	891	4,831	2,202	7,924	9,361	-15.4%
TOTAL ASSETS	40,050	127,669	14,045	181,764	181,655	0.1%
EARNING ASSETS	35,952	107,188	11,513	154,653	161,591	-4.3%
LIABILITIES						
TOTAL DEPOSITS	35,653	102,648	8,938	147,239	144,006	2.2%
DEPOSITS OVER 100M	8,082	25,584	3,165	36,831	40,852	-9.8%
BROKERED DEPOSITS	47	1,871	352	2,270	740	206.8%
FEDERAL FUNDS PURCHASED	861	10,789	1,025	12,675	17,497	-27.6%
SUBORDINATED DEBT	20	373	733	1,126	427	163.7%
OTHER LIABILITIES	613	8,537	3,058	12,208	11,778	3.7%
TOTAL LIABILITIES	37,147	122,347	13,754	173,248	173,708	-0.3%
TOTAL EQUITY CAPITAL	2,904	5,322	292	8,518	7,947	7.2%
TOTAL LIABILITIES & EQUITY	40,051	127,669	14,046	181,766	181,655	0.1%
EARNINGS						
INTEREST INCOME	1,850	5,161	236	7,247	7,091	2.2%
INTEREST EXPENSE	1,110	3,695	235	5,040	4,777	5.5%
NET INTEREST INCOME	740	1,466	1	2,207	2,314	-4.6%
NON-INTEREST INCOME	196	1,170	267	1,633	938	74.1%
LOAN PROVISIONS	183	629	89	901	2,834	-68.2%
OVERHEAD EXPENSES	669	2,145	173	2,987	3,332	-10.4%
EXTRAORDINARY ITEMS (NET)	7	8	0	15	7	114.3%
NET INCOME	61	(145)	6	(78)	(2,895)	-97.3%
CASH DIVIDENDS	54	118	15	187	164	14.0%
FINANCIAL RATIOS					%	
TE/TA	7.3%	4.2%	2.1%	4.7%	4.4%	7.1%
TE&R/TA&R	8.3%	5.5%	2.1%	5.8%	6.8%	-14.0%
NPFMG+ORE/TE	57.1%	141.3%	1180.1%	148.2%	168.9%	-12.2%
NPFMG+ORE/TA	4.1%	5.9%	24.5%	6.9%	7.4%	-6.0%
NPFMG/TOTAL LOANS	4.7%	7.4%	26.0%	8.5%	9.2%	-7.4%
LVR/TOTAL LOANS	2.4%	2.7%	0.0%	2.4%	4.6%	-48.1%
PPLL/TOTAL LOANS	1.9%	1.9%	2.1%	1.9%	5.6%	-65.2%
NET INTEREST MARGIN	4.1%	2.7%	0.0%	2.9%	2.9%	-0.3%
INT.INC./PRINCIPAL INCOME	79.1%	55.6%	0.4%	57.5%	71.2%	-19.2%
NON-INT./PRINCIPAL INCOME	20.9%	44.4%	99.6%	42.5%	28.8%	47.4%
Return on Average Assets	NA	NA	NA	NA	NA	NA

Appropriate Financial Ratios are Annualized
NA = Not Available
Principal Income = Net Interest Income + Non-Interest Income.
Minor differences from actual results could occur due to rounding and/or various banks being omitted from the database.

Texas Department of Banking

Exhibit III

REGULATORY PROFILE

	8/31/86 1986	8/31/87 1987	8/31/88 1988	11/30/88 1989 1	2/28/89 2	5/31/89 3	8/31/89 4
No. Institutions	893	878	740	687	672	665	648
No. Institutions Closed	10	21	43	6	12	14	*15

* Includes one private bank.

Banks Not Examined

	As of 10/1/87	As of 12/1/87	As of 3/1/88	As of 8/31/89
In last year	424	400	311	137
In 2 years	130	116	73	7
In 3 years	81	77	40	1

BANK FAILURES
(through 8-31-89)

YEAR	TEXAS			NATIONWIDE
	STATE BANKS	NATIONAL BANKS	TOTAL TEXAS	
1981	0	0	0	10
1982	4	3	7	42
1983	1	2	3	48
1984	2	4	6	79
1985	5	7	12	120
1986	14	12	26	145
1987	*22	28	50	186
1988	43	70	113	200
1989	**39	70	109	151

* Includes two private banks.
** Includes one private bank.
Through August 31, 1989.

Texas Department of Banking

Exhibit IV

EXAMINATION PERFORMANCE
SUMMARY
(Fiscal Year)

	8/31/86	8/31/87	8/31/88	11/30/88	2/28/89	5/31/89	8/31/89	Total FY
	1986	1987	1988	1989				1989
Bank Examinations				1	2	3	4	
Regular	213	239	297	88	99	115	103	405
Abbreviated	7	-	18	12	11	7	17	47
Joint/Concurrent	90	113	99	14	18	4	4	40
Total, Banking Department	310	352	414	114	128	126	124	492
FDIC (Independent)	140	215	209	78	18	14	27	137
FRB (Independent)	34	37	49	5	4	1	1	11
Total, Bank Examinations	484	604	672	197	150	141	152	640
Trust Examinations								
Trust Companies								
Regular	11	24	38	6	6	6	12	30
Abbreviated	0	0	0	6	16	24	26	72
Trust Department of Banks								
Regular	14	15	27	4	6	2	3	15
Abbreviated	0	0	0	0	0	0	0	0
Total, Banking Department	25	39	65	16	28	32	41	117
FDIC/FRB	13	7	20	9	4	1	0	14
Total Trust Examinations	38	46	85	25	32	33	41	131
EDP Examinations	55	37	55	9	13	9	12	43
Perpetual Care Examinations	149	186	178	41	14	42	52	149
Prepaid Funeral Contract Examinations	530	537	494	114	61	70	125	370

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Exhibit V

		1987	1988	1989 (YTD)
	Charters			
Filed -	New Charters	0	2	1
	Conversions	3	3	1
	P & A s	4	6	4
	Trust Companies	1	1	0
	Total	8	12	6
Approved -	New Charters	2	0	0
	Conversions	3	1	1
	P & A s	4	6	4
	Trust Companies	1	1	0
	Total	10	8	5
Denied -	New Charters	0	0	0
	Conversions	0	1	0
	P & A s	0	0	0
	Total	0	1	0
Withdrawn -	New Charters	9	1	1
	Conversions	2	0	0
	P & A s	0	0	0
	Total	11	1	1
Open -	New Charters	9	0	1
	Conversions	2	1	1
	P & A s	3	6	4
	Trust Companies	1	0	1
	Total	15	7	7
Pending -	New Charters	2	1	0
	Conversions	1	1	1
	P & A s	0	0	0
	Trust Companies	0	1	0
	Total	3	3	1
	Mergers			
	Pending	5	5	4
	Filed	24	18	14
	Approved	24	18	9
	Withdrawn	0	1	2
	Pending	5	4	6
	Denied	0	0	1
	Branches			
	Pending (beginning of period)	3	8	7
	Filed	89	105	75
	Approved	80	101	59
	Denied	2	1	3
	Rescinded	2	4	4
	Pending (end of Period)	8	7	9

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Exhibit VI

SUMMARY OF ADMINISTRATIVE ACTIONS AS OF 9-30-89

ACTION

COMPOSITE RATING	N/A	BR	CL	MOU	NOD	C&D	TOTAL	SUP
5	0	0	1	3	15	22	41	11
4	5	5	2	39	57	18	126	10
3	41	32	14	57	7	1	152	2
2	188	14	14	8	0	0	224	0
1	96	1	1	0	0	0	98	0
0	5	0	0	0	0	0	5	0
TOTALS	335	52	32	107	79	41	646	23

LEGEND

N/A:	No Action
BR:	Board Resolution
CL:	Commitment Letter
MOU:	Memorandum of Understanding
NOD:	Notice of Determination
C&D:	Cease and Desist Order
SUP:	Supervisor

Exhibit VII

TEXAS DEPARTMENT OF BANKING
1989 RECONCILEMENT OF ADMINISTRATIVE ACTIONS
(COMMERCIAL)

	BEGINNING BALANCE 8-31-89	ADDITIONS	DELETIONS	ENDING BALANCE 9-30-89
SUPERVISORS	23	1	1	23
C&DS	42	1	2	41
NOTICES	78	3	2	79
MEMORANDUMS	106	8	7	107
COMMITMENT LETTER	32	1	1	32
BOARD RESOLUTION	51	1	0	52
TOTAL	332	15	13	334

Exhibit VIII

TEXAS DEPARTMENT OF BANKING
INFORMATION SUMMARY

	FISCAL 1984	FISCAL 1985	FISCAL 1986	FISCAL 1987	FISCAL 1988	FISCAL 1989
Number of State Banks (as of 8/31)	847	874	887	880	740	648
Number of Problem Banks (CAMEL rating 4 & 5)	27	55	84	164	186	169
Problem Banks as % of Total State Banks	3.2%	6.3%	9.5%	18.6%	25.1%	26.0%
Number of Banks with CAMEL rating 3	64	73	102	172	158	156
Bank Examination Activity						
Banking Department	385	276	220	239	315	452
Joint Examinations	26	37	90	113	99	40
FDIC Examinations	90	106	140	215	209	137
FED Examinations	21	24	34	37	49	11
Examinations in Fiscal Year	522	443	484	604	672	640
Number of Examiners						
at 9/1/FY	78	69	97	98	123	149
Terminations	-32	-29	-24	-14	-28	-27
New Hires	23	57	25	39	54	50
Transfers						-7
Examiners at 8/31/FY	69	97	98	123	149	165
FTE for Fiscal Year	72.9	73.4	95.7	105.2	144.4	
Entry Level Salary	$16,584	$17,076	$18,180	$18,180	$18,540	$18,540
Commissioned Examiner Salary	$23,784	$25,320	$26,076	$26,076	$29,364	$32,412
Salary Maximum (field examiner)	$37,680	$38,808	$39,972	$47,500	$48,450	$48,450
Total Appropriations	*	$4,970,583	$5,947,769	$6,023,748	$8,971,557	$9,182,342
Total Expenditures	*	$4,402,084	$4,625,864	$5,264,999	$7,299,097	

* prior to 9/1/85 the Banking Department operated on a calendar year budget, changing to a fiscal year basis in FY 1985.

The CHAIRMAN. Very good. I find those very thoughtful and thought-provoking comments on your part.

Senator Graham and Senator Bond, do either of you have any overview comments you want to make here at this point with respect to the discussion?

Senator BOND. I'd like to ask a few questions but I will wait.

Senator GRAHAM. Mr. Chairman, I apologize for arriving late, particularly after my good friend Gerry Lewis had already commenced his remarks. Gerry and I entered the Florida legislature together in 1966, so we have all had an opportunity to see many of these issues as they have evolved and our State has been very well served by his leadership in this position which as your questions indicated has a very comprehensive responsibility for financial institutions in Florida.

The CHAIRMAN. I'm going to pose just one question and then I want to use the time to let everyone here get into the discussion.

As you know in the thrift legislation we asked the Treasury and the GAO to take a look at the deposit insurance system. There are a lot of points of view kicking around as to whether or not there ought to be some adjustment in levels, or some way of otherwise altering the Federal deposit insurance system as it presently exists.

I'd be interested in your respective thoughts as to whether or not you think we ought to seriously consider changes in that area, or whether you generally are satisfied with the way things are presently. Mr. Gilleran.

Mr. GILLERAN. Well, I certainly believe that it requires a lot of discussion and analysis and good communication. I, myself, at this time have no number to suggest that's better than the $100,000 amount. If you went back to when deposit insurance was formed, I would imagine that the coverage at that time plus all the inflation factors we've had since the 1930's, probably $100,000 is probably pretty close to what it was when it originally started or thereabouts.

A factor which is a major part of what the FDIC funds have covered has been the fact that they have been holding all deposits even above the $100,000 level whole. Therefore, if individuals or corporations would have deposits that were greater than $100,000 they also have been protected by their operations.

I believe that that is an area that should be reviewed in terms of whether or not that continues to be necessary because that is a part of what is being covered by the fund at the current time.

The CHAIRMAN. Mr. Brown.

Mr. BROWN. Senator, I eagerly await the results of the joint study, not having much power to do anything about it one way or the other. I view that as a worthwhile academic exercise certainly at the outset.

Just some observations. We've seen generally that problems have been encountered by the institutions where there are large brokered deposits, where institutions have taken advantage of the safety net which I think primarily was intended for the smaller consumers, those not sophisticated enough to really read market risks. And I think that the study should perhaps concentrate on that and maybe skew the system back toward the smaller depositor who may in fact need this type of protection much more so than the institutions.

The CHAIRMAN. An interesting thought. Mr. Lewis.

Mr. LEWIS. I would tend to agree with both of my colleagues, Mr. Chairman. I would underline what Mr. Gilleran said about the level. I know there's a lot of discussion about that. I have a real concern. I think consumers have a confidence level in the system because of insurance and I fear that any lowering of that amount could have an impact on the confidence that the consumers have. Whether or not it is a realistic level, I would be very concerned about tinkering with it.

The CHAIRMAN. Mr. Littlefield.

Mr. LITTLEFIELD. I think it's a very important issue. There's always a tradeoff on these issues. The issue of market discipline is one that's been discussed with regard to the deposit insurance system by either lowering the deposit insurance amount or somehow treating certain types of deposits as uninsured creates more market discipline.

I would point out that we in the bank regulation have gone out of our road to avoid market discipline. Indeed, with the larger bank failures in Texas, the FDIC has come in and guaranteed 100 percent of the deposits of the larger institutions. Market discipline would be to let the runs on the banks go and to let the system collapse. I supported the FDIC. I think that was good for Texas and it did protect the financial industry in Texas to do that.

So I think if we're going to use the deposit insurance as an element of market discipline I think we need to be very careful about how we do that because market discipline sometimes works counter to the best interest of the financial industry.

I think we need to look at the purpose of deposit insurance. If it's there to be a safety net for savers, a safe place for them to put their funds, I think maybe that should be our focus and what the amount should be and who should get it. There have been problems with brokered deposits and I agree that that needs to be addressed.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

Let me say to all of you I appreciate so much your input and your thoughts this morning. Like so many of us, I find myself constrained by time and have to go off to another series of meetings and would like to spend hours involved in discussions with you.

I want to kind of focus my attention on Mr. Littlefield and Mr. Lewis if I can, certainly not intending to slight the gentlemen from California and Connecticut.

Gerry, Mr. Littlefield mentioned a little earlier CAML, which is a rating system that the Comptroller of the Currency uses to talk about capital adequacy and asset quality and management, liquidity, earnings.

Do you have a system similar to that? If you do, could you give us an indication of how you evaluate the banks in Florida in the sense of the number of troubled banks that you're dealing with and what you see the outcome of those troubled banks?

Mr. LEWIS. Well, Senator, we use the exact same system of ratings and it is a guide. It's not absolute. We may have a bank rated a three but that doesn't mean it's necessarily bad. There may be just some areas we're looking at. It's a combination of other factors that you indicated.

We don't actually keep a list as the FDIC does of troubled institutions as such and I think overall our State-chartered banks are in good shape in Florida. We have some that are not doing as well as we'd like but they are really small in number and we're monitoring them and doing what we can. I think we ought to realize—I know you know this—sometimes the public tends to think when they hear about regulators—regulators can't manage an institution. I think Mr. Littlefield's comments about being pro-active in the indicators he gave is absolutely the way that we have to go and my understanding from the Comptroller of the Currency is that is exactly what he has been doing. Mr. Clarke has been very aggressive in trying to do that to get ahead of problems and identify what may lead to problems as opposed to coming in with the examination after the fact.

But there's still a limit to what you can do even in a regulated industry because you've got to let them manage the institution. And some are going to fail and that's where the insurance comes in. You want your depositors protected. But again, even in a regulated industry, we are in a free enterprise system, and sometimes the owners are going to lose. We're not happy about that, but as long as the system is sound, then I think you accept certain failures as you do with any other kind of business.

Again, I might just expand on that. I noticed, Mr. Chairman, in your opening remarks you made reference to the equity capital of State-chartered banks in California and Florida and I just literally sent out to you the numbers and I would like to get with your staff on that because our numbers show that our capital asset ratio of State-chartered banks is 7.2 percent compared to national banks which are 6.27 percent. So our feeling is that our State-chartered banks are in good shape but I would like to get with your staff.

The CHAIRMAN. By all means. We want it accurate. Sometimes the data is out of date or errors are made. So we want to make sure we have it straight.

Senator MACK. Thank you, Mr. Lewis. Let me get to Mr. Littlefield if I could.

I know that all the hearings that we had and the deliberations that we had with respect to putting together the S&L package that was passed earlier this year, everything seemed to focus on the word capital—capital adequacy—and what that level should be, should it be 3 percent, 4 percent, 6 percent.

In listening to your discussion, I was struck by the possibility that there really was not a level at which Texas banks could have been capitalized that would have solved the problem to have kept FSLIC from having to come in and solve the problem. There is a tendency for us to think that the fraud and insider dealings and some minor economic problems created the situation in Texas, but in listening to you I couldn't help but think that the economy of Texas was hit so badly with respect to real estate and oil that there virtually—surely there could have been a level at which capital would have been adequate, but I don't know whether that would have been 15 percent or 20 percent or what. I guess I want to get you to kind of react to that.

Could we have really solved the problem in Texas if we had increased capital requirements from 4 percent to 10 percent?

Mr. LITTLEFIELD. That's an excellent question, Senator, and the obvious answer to that is no. I don't think any amount of capital could have kept some of those banks from failing. Banks fail because of poor management generally and not because of inadequate capital generally. The purpose of capital is——

Senator MACK. I'm sorry for interrupting but again I mentioned I was in the banking business and I guess some of us may react from time to time—it's awful easy to say that the reason for the failure was bank management. But I would suggest that there is a tremendous problem if the loans that you made according to most standards with the proper downpayments, the proper investor capital involved, the bank had written up certain requirements on those loans—all of that goes out the window if the asset value drops 50 percent or 75 percent and then there's a tendency to come back in later on and say, well, if management had just done something a little bit differently we wouldn't have had these problems. I'd be interested in your reaction to that.

Mr. LITTLEFIELD. Well, I think we're in the matter of degrees. Once again, I've got a whole list of reasons here. Mismanagement is only one of those factors. Obviously, inflation and good economic conditions cover up some poor management practices. A recession or a severe recession as we had in Texas exposes those management practices.

I think there's been some of each. For example, I guess I'm from a more conservative lending background and as Senator Bond knows from Missouri we're pretty conservative there, but the idea of loaning 100 percent on an appraised value was something that probably a prudent banker shouldn't do and it's probably undue risk. I might add that in Texas there are no exotic banking powers given to banks. All of our banking problems were earned the old fashioned way—we did it through the lending desk. So I think when you talk about mismanagement—I know the Comptroller did a very in-depth study of that and concluded that something like 80 percent of banks failed because of management, but I assert that 100 percent of banks fail because of management. The success of failure of a bank is the responsibility of management, but the point you raised is a very good point and it's one that Texas bankers try to defend themselves with all the time. That is, how can you manage a bank in a marketplace where you have a 50 percent devaluation in the collateral base on which you loaned and how much capital is adequate in that kind of market situation? It's not all bad management. Some of it is just circumstance. However, liberal lending practices, which is a phrase that regulators use all the time, have been a contributing factor in Texas and I hope that other parts of the country their bankers can take a lesson from that and say, "Look, let's be a little more conservative in the way we go about making real estate loans."

But banks don't fail generally because of inadequate capital. They fail because of the way the bank is being managed, whether it's more aggressively which makes it more susceptible to economic downturns, or whether it's more conservative which makes it able to weather economic downturns better.

Senator **Mack**. If I could, Mr. Chairman, let me just ask one more question of Mr. Lewis.

Florida has been experiencing tremendous growth over the years and many have said there were either too many banking offices, whether that's S&L's or commercial banks.

How many new banks have been chartered in Florida over the last 3 to 5 years from your office and is there a concern as to the growth of banking offices?

Mr. **Lewis**. Senator, I have the numbers if I can find them, but while I'm looking let me say that the number of applications for de novo charters has dwindled. We now have approximately five pending and not surprisingly there isn't any savings and loan activity in chartering.

Senator **Mack**. Do you have a higher capital requirements for de novo banks today than 5 or 10 years ago?

Mr. **Lewis**. Yes, we do. In fact, last year we asked the legislature to increase that and they did. We doubled the capital requirements for de novo banks and I do have the numbers. This year to date we've received five applications. Last year, 16. The year before that, 40. The year before that, 38. In 1985, 23, and it was about at that level. But it dropped off significantly and I think part of that is the consolidation of banks, the growth of the super-regional banks, and frankly we started a couple years ago to make clear that we were going to be a lot stricter in the chartering process.

I'm a firm believer in a locally owned community-based bank and if that seems somewhat contradictory it's not. I really encourage these banks. I think they are absolutely essential to the economic well being of our State and I feel that way about the country.

At the same time, a lot of our failures were in banks that have been open 2 years or less and as we looked at it we found exactly what Mr. Littlefield said. You're talking about bad management, people who when they apply for the charter may not have really been serious about what they were getting into. I have another phenomenon which is the consultant generated application. There's nothing illegal about it, but people make a lot of money as consultants and they go out and round up a group of people and sell them on the idea that this is a nifty way to make a lot of money and we found that we could not under Florida statutes deny some of these applications because there was nothing wrong with the people. They could raise the capital. But we've just gotten a lot tougher. We spend a lot of time now with the organizers trying to find out exactly what they have in mind and if they understand what they are getting into and understand what the banking business is about, explain to the directors exactly what directors' liability is and try to discourage the idea that it's a lot of honor and nothing else much involved. There's a tremendous liability that goes along with it. So what we're seeing is fewer, but much better applications.

Senator **Mack**. I thank you.

Senator **Graham** [presiding]. Thank you. Our chairman has had to leave, so I will preside over the balance of the meeting and conclude, which is some indication of the momentum of this meeting.

I would like to ask a question which starts with a premise that it's important in this financial services industry for people to have a sense of stability and predictability of what is occurring. That is fundamental to the necessary confidence of the public in our financial system.

There are clearly some very fundamental new currents underway. Those include, but are by no means limited to, the increasing degree of global competition that is affecting all of our financial institutions, regional consolidation in New England and the south and elsewhere particularly, some of the changes that came as a result of the savings and loan bill that you have previously commented are likely to begin to blur if not eliminate the distinction between commercial banks and thrift institutions.

With those currents as well as others underway, what would be your recommendation to this committee that it ought to have as its principles as it attempts to look at restructuring of the pattern of Federal laws that relate to financial institutions in order to be responsive to these changes but to make the changes as graceful and as nondestabilizing as possible?

I would editorialize that question by saying I am a strong believer in the dual banking system and so your comments as to how to accomplish that objective from the perspective of state regulators and the maintenace of a dual banking system would be particularly appreciated.

Mr. GILLERAN. I think it's an excellent question and my number one concern as a citizen as well as a regulator is the competitiveness of U.S. banks going forward. There's been other testimony at this committee in terms of the aggregate total capital committed by certain nations to its banking industry versus what is available here in the United States.

So I think the starting point should be what do we want our banks to be here and how can they be competitive with banks around the world. I think this discussion is extremely important going forward to 1992.

I think that once we decide what it is that we want to be, the subject of powers sort of sorts itself out and I believe that the term deregulation has been sort of a problem in itself in that I don't believe that by increasing the powers of financial institutions or other industries would necessarily mean that we deregulate them because I don't believe that we should cut back on the supervisorial powers by the regulatory agencies or in any way to undermine their ability to satisfy us all that what we decide to do as a country to make ourselves competitive is in any way going to get out of hand.

Senator GRAHAM. Mr. Brown.

Mr. BROWN. Senator Graham, in response to that same question, I suppose a starting point would be to go back and look at some of the Federal legislation that was enacted in the 1930's and do an honest appraisal of whether it's antiquated, cull out what really is no longer applicable. We've created several safety nets through the 1933 and 1934 securities acts. We've seen those safeguards come into action certainly in the October 1987 stock market stressful period that we went through and we've just seen it again over this past weekend. So I think that highlights what should really be a critical appraisal of the Glass-Steagall prohibition between mixing commercial banking and investment banking. That certainly has a direct bearing on the economic initiatives that will come into full play in 1992 vis-a-vis the competitive posture of the U.S. banking industry.

Along with that goes an analysis of the McFadden limitations on bank branching as opposed to expansions through bank holding company actions and whether or not there are any real crucial differences. Differences will most likely impact on how the State regulator can treat a given bank within the geographic boundaries that he or she is charged to maintain.

As to the dual banking system—this is my druthers—I would like to see an emphasis placed more so on the ability of the State regulator to respond to a local economic environment and have that serve as the focal point of retaining and strengthening the dual banking system rather than a lot of flag waving and phraseology regarding states rights.

The real issue there is whether or not the local regulator can respond to the local banking environment and that is the real crux of why we must preserve the dual banking system.

Senator GRAHAM. Thank you, Mr. Brown.

Mr. Lewis.

Mr. LEWIS. Senator, I also agree with your concerns. In fact last week there was an article in the Wall Street Journal that was really scary about the competition especially from Japanese banks and I think it is imperative for this country that our banking industry be competitive.

Just to pursue something Commissioner Gilleran was saying, the term expanded powers has developed a connotation that I think is somewhat unfortunate. It doesn't necessarily mean that it's all bad and it doesn't mean deregulation. For example, one issue that I know is very controversial, the question of giving the banks insurance powers. That does not necessarily involve any additional risk. You're not talking about underwriting the risk but rather the sales of insurance. You're just talking about an added benefit to the consumer, more sources of insurance and at the same time additional powers. That's just one example.

I think also in other areas, whether it be securities or whatever, the fire wall concept separates that from the insured part of the institution and you're obviously familiar with all these kinds of proposals. But I would suggest that is very important.

Under your leadership when you were Governor of Florida you spearheaded the regional interstate banking for the Southeastern States and I'm one of those people who believes that's been very successful and I think that is moving us toward a system of interstate banking that is good. I think ultimately what we will wind up with will be several tiers of banks and I think that's going to be healthy.

Finally, let me say I actually believe that the question of the geographic limitations has almost become irrelevant. You and I had a discussion one time as I recall and we were talking about whether in fact the combination of technology and the nonbank type institutions hadn't really made this argument over geographic limitations somewhat irrelevant and I feel that's true. I think we ought to get on with the question of services, powers, and how banks can really be competitive in a global economy.

Senator GRAHAM. Mr. Littlefield.

Mr. LITTLEFIELD. I'm not sure I can add too much to that. I think you've got to start maybe with some very fundamental questions. What is a bank? Second, who can engage in banking?

I'm concerned that we've created a banking structure that is going to fail because of the way it's created and set up. There's nothing that a bank can do that someone else can't do at this point in time and yet banks can't do a lot of other things.

I agree that there's been an overreaction to the word "powers" because of some unfortunate failues in the S&L industry but there hasn't been that many failures in the banking industry to look at as an example. But we've created a banking industry that competes very competitively for automobile loans with General Motors Acceptance Corp. and Ford Motor Credit. Banks are no longer the preferred or the most efficient way for corporations to finance their working capital credit. That used to be a staple for them. Consumer credit with all of the nonbanks offering consumer credit cards and different kinds of consumer credit, that's no longer a staple for bank profitability. It's sort of like the U.S. Postal Service or the airline industry that has a highly competitive environment for the profitable routes and they're left with the unprofitable routes.

What the banking industry is left with is commercial lending and commercial lending is probably the highest risk type of asset for a bank to invest insured deposits in. So I'm concerned that through regulation and restraints we have created a banking industry that cannot be profitable in a highly competitive marketplace and that concerns me. It also concerns me when we justify perhaps lowering capital standards by saying that we have to do that to make return on equity higher so that we can attract capital to the banking industry. I think maybe we need to look elsewhere to make the banking industry a profitable business if it's going to be the preferred place for customers to put deposits that's going to finance our economic expansion and to do it efficiently and effectively so that we can compete with other countries. In most other countries their banks can engage in other types of activities in a safe and sound way and I would emphasize safe and sound every time we talk about new powers, but I think we need to address that issue. Congress needs to address that issue.

Senator GRAHAM. Thank you very much. Those were excellent responses. I appreciate your thoughtful contribution.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman. I agree those are good ideas and good things for us to consider.

I might ask just a few questions. Ken, you said you were behind the regulatory curve at the beginning. Have you been able to build a staff that really enables you to make the pro-active judgments. Is new training required? Are you getting the resources you need or are they still stingy as we were in Jefferson City?

Mr. LITTLEFIELD. Senator, we've had a great deal of success in that I think the Texas legislature has been responsive to a crisis situation and has been very generous with the banking department in providing those resources. We've had significant increases in budget. We've gone from 98 examiners as of August 31, 1986 to 165 examiners on August 31, 1989.

We've had the salary of examiners removed from the legislative purview and placed with the State Finance Commission and they are professional individuals, successful individuals, in the private sector who understand market competition for examiners' services and they will set the salaries and we have a salary proposal before them now that is competitive with the federal regulators in terms of salary for examiners. We have had in the past very high turnover and a very inadequate salary structure, as I think most regulatory agencies have because our salaries have been compared to the wrong people. We've been compared to social services and other types of State agencies or Federal agencies and that's not the competition for bank examiners. We hire bright young folks and can give them good training and if they impress a banker in examining a bank they are oftentimes offered a much better job in the private sector and that's been a source of problem for us. But I think a real key to your question lies in the amount of expertise that's going to be required to be a pro-active bank regulator and that is a critical question because it touches on the question that Mr. Lewis talked about and that is are we getting into management of the bank when you become more pro-active there. And it's a narrow line that has to be drawn, but I view the regulator as a traffic cop and when the traffic gets going too fast it's the regulator's responsibility to start issuing tickets and issuing warnings that there's a danger ahead and we've always been in that posture. But I think it takes a very well trained examiner, someone with experience, that can go in and draw that line between being active in management of the bank and being a traffic cop and says you're beyond safe and sound limits and you need to make a course correction.

Senator BOND. We have discussed on many occasions in this committee and elsewhere the dual banking system. What do you think is an appropriate response from Congress perhaps if there are State banking regulatory agencies that are not measuring up? If they've got FDIC insurance they obviously have some Federal supervision there, but what's your view on how concerned we should be about this?

Mr. LITTLEFIELD. Senator, the system we have in place has worked very well. The FDIC has been that safety net for state banking departments that haven't lived up to their responsibilities and provided good bank regulation and I think they've done a good job of that. They have been there for the States that didn't do the job and the States that have done a good job they've been willing to take more of a back seat role in the examination and supervision functions. That's still there and I think if properly structured in the future will continue to allow a dual banking system and allow the states to go forward and provide for the structure within that state that they need.

Senator BOND. I'd ask one further question and then ask all of the panel members to comment on it as Senator Graham did a few moments ago.

Given what we've heard today and you four gentlemen have presented us, are there specific actions that you would recommend that we in this committee consider? I know that some of the ideas that you have all raised, the idea of pro-active regulation, looking for problems in advance—are there steps we should be taking here with respect to the safety of the system? Do you have any thoughts or ideas for us?

Mr. LITTLEFIELD. Senator, I'm not sure I have any that we haven't already discussed. I would just encourage the committee to be mindful in deliberation of the success of the dual banking system over the years. It's been a very successful system. It's provided for a very responsive type of banking services to the local communities. The 640 banks that I'm responsible for, many of them—most of them are local community banks who are doing an excellent job serving their community and they are not influenced or twisting because of Japanese competition or a lot of factors that some of our larger metropolitan area banks are.

So I think that in your deliberations I would hope that you would be mindful of the long tradition and the long success of the dual banking system and try not to do anything that would harm that.

Senator BOND. In other words, do no harm.

Mr. LEWIS. First, on the question of the quality of State banking departments, I know that that is number one priority of our national organization, the Conference of State Bank Supervisors. They realize, as I think we all do, that though we strongly support the dual banking system, if our State departments of banking aren't able to do the job then it doesn't do us much good to talk about a nice concept and I can tell you it is very serious with all of us and with our national organization. Education of our examiners is stressed. In Florida we have also been accredited by the Conference of State Bank Supervisors and let me say that's not a pro forma thing. It's a long process. It's a very difficult process and it gets into everything from salary structure to competence of examiners and so on.

We have been fortunate—when Senator Graham was Governor, he initiated legislative action that gave us significant pay raises all across the board for all of our people—bank examiners, securities examiners and so on. At that time entry level salary was around $14,000 and we couldn't hire people with the education requirements that we had and we couldn't keep them if we did. We're at about $20,000 now as an entry level and we're in the ballpark on that. We always would like more. I wrote down the salary scheme in Texas which is very appealing to me because as you know it's very tough at the State level as at the Federal level where dollars are short and you're competing with every other entry space. But we have had significant improvement starting with Governor Graham's administration and in terms of any recommendations, I would commend you for tackling the thrift crisis and enacting legislation. Whether there will be glitches in it—and I say this not as a criticism but any massive piece of legislation will turn up areas that perhaps were not foreseen—I hope in one area—I started off before you were in here stressing what to me is a primary concern and that is cooperation between Federal and State agencies. I hope that the RTC does not turn into a couple extra levels of bureaucracy that does not work as well as the FDIC does with us, but that's not something that you can really legislate, but I hope there will be some oversight of that because the mechanism is there to do the job and I'll frankly know more within the next year because in Florida we do have a sunset process of all our regulatory laws. The banking code will be sunsetted in 1991. I have just appointed a task force of leaders in the industry, academia, consumer areas, to study this whole area at the State level and that will necessarily include looking at FIRREA to see how that interacts to see what perhaps we should be doing better and how the law could be improved. So we're going to be doing our own analysis over the next year.

Senator BOND. Mr. Brown.

Mr. BROWN. Senator, in response to your question regarding what the Congress can do, I think one thing that would be illustrative of which direction we should be headed in is looking at what resulted from the diversified portfolios that those successful States or those states that survived the economic stressful times—they had diversified portfolios. That's always been considered as a safety measure, a protection against any single sector of the economy going through depressed times. That diversified economy came about as a result of expanded powers. There's no way that you can have a diversified loan portfolio or asset based portfolio and not have the ability to go into areas other than one to four family residential mortgages for instance.

So in looking at that I think we have to think in terms of the trip has begun. We really can't go back to the time when banking was considered the safe, mundane manner of holding funds. It's more than that now. It's a different industry. It's also a publicly held industry and unless we continue to deal with expanded powers and massage and be critically analytical of the expanded powers that we are allowing the banks to exercise—if we don't do this we will end up losing the United States banking industry as we now know it. They are publicly owned institutions will be simply bought out unless we give them the powers to compete and to compete on a global scale.

Senator BOND. Mr. Gilleran.

Mr. GILLERAN. One area of frustration in California is that we have these expanded powers in real estate. We believe they have been conservatively applied, safely applied and well regulated. It is a frustration to many of our banks who have holding companies that when they apply for activities within the holding company the Federal Reserve will not allow them to have these expanded real estate powers because they do not like them. So I believe one thing you could help us straighten out is this regulatory supervision of expanded powers because I concur with what Mr. Brown has said, that if we want our banks to be healthy to be competitive that we've got to deal with them effectively, but it seems like the regulatory aspect of it has to be sorted out.

Senator BOND. Thank you, gentlemen.

Senator GRAHAM. I understand that you have to leave to catch a plane, Mr. Gilleran.

I have one last question which is in response to an earlier question and if you would like to amplify any comments from Mr.

Brown or Mr. Littlefield—that is the effect of the regional banking compacts which have developed in the last decade.

What is your assessment of the impact these are likely to have on the dual banking systems within your individual states and in terms of the pace that that might create for national interstate banking?

Mr. BROWN. The overriding influence within the regional compact that we have in New England is pretty much the strength of the larger regional institutions view as to whether or not it's going to really contribute to the bottom line of that institution to allow competitors to come in and they will only do that in terms of their being allowed to go into other areas.

What we are seeing now is that certain attractive regions that the New England institutions would like to expand into are not really welcoming as readily those institutions. So we are seeing regions recoil from added competition.

I think through some of the aspects of FIRREA we will see gradual inroads being made into those geographic compacts that have to date refused to expand further and I think that will be a compelling influence to force them to come back and look at the full picture and expand on a national basis. I think certainly some of what in essence amounts to reciprocal requirements, although they have been softened I'm told, regarding the economic community initiatives to take place in 1992 will certainly have an effect on the ability of European and Japanese banks to freely bank from Connecticut to California and I think that's going to be a very significant influence on the national banking or the full lowering of the barriers to interstate banking.

Mr. LITTLEFIELD. I might just comment very briefly on that. The regional interstate banking is a relatively new concept over the last 7 or 8 years and among other things it's created a more competitive banking environment with the breaking down of the State barriers to provide more competition among banking but it's also created a more complex regulatory scheme for banking when we have multi-bank holding companies operating across State boundaries. That particularly has been brought to light with the provisions of FIRREA. The cross-guaranty provision of FIRREA. For example, I have a small State-chartered bank in Brownsville, Texas that the success or failure of that bank depends on perhaps actions of a large multinational bank in New York City because the Texas corporation is owned by a New York banking concern and then in turn the State-chartered bank is owned by the Texas concern. So, because of the cross-guaranty provision, loans to developing countries or highly leveraged transactions that are conducted by a bank in New York have an impact on the survivability or the future of a small State-chartered bank in the valley, which brings me to a concern that I would like for the committee to be aware of and that's the way the cross-guaranty provisions are used by the FDIC.

Let me say first of all that I agree with the general concept of the cross-guaranty, what the objective of that provision is. A holding company shouldn't be allowed to flush its losers down the tubes for the FDIC to pick up the tab and then have the stockholders benefit from the winners in a multibank system.

What I'm concerned about is that if the FDIC levies a judgment against a healthy bank, it could end up costing the FDIC fund more than if they didn't levy it. I can give you a specific example if you have time on how that would work.

Let's say we have two banks in Texas. They are both $100 million banks and one of them has failed and it's cost the FDIC $15 million. The other bank is a $100 million bank and let's say it's a 3 rated bank and it has 6 percent equity to asset ratio which should give it $6 million in capital. So the FDIC would levy $15 million, which is the cost of handling one failure—they would levy that against the other bank that had only $6 million in equity, which would create a failure because now we have a judgment against that bank greater than its equity capital.

If it's a State-chartered bank that the judgment is levied on, I would have no option at that point in time than to close the bank. If the FDIC were to sell that bank under a TAPPA procedure which is sort of the epitome of the definition of a fire sale because you sell off all the assets in a bank on a current market basis—if the FDIC were to sell that 3 rated bank under a TAPPA, it would probably cost them 15 to 20 percent of the total assets of the bank as a cost.

So it would end up costing them say another $15 million which is greater than the capital. So by exercising the cross-guaranty they may actually increase the cost to the FDIC fund rather than save money. I hope and in my discussion with the FDIC would like to encourage them to use that power diligently. Perhaps some formulas in terms of how much they are going to levy against a healthy bank might be useful. But that is a situation that is exacerbated by the regional interstate banking and indeed nationwide banking where we can't regulate the entity within our State boundaries because it is impacted dramatically by another bank in some other part of the country.

Senator GRAHAM. Gerry, you commented on this in your earlier statement. Do you have anything you would like to add?

Mr. LEWIS. Just that our experience in terms of handling of the regulatory responsibilities across state lines I've have been very pleased with the cooperative effort we've had with both the Federal agencies and the other states. We have been working together and really it's working out very smoothly, perhaps even better than one might have anticipated.

Senator GRAHAM. Again, on behalf of the committee I would like to express my appreciation for your very significant and helpful testimony today. This is part of a series of hearings as the chairman indicated on the state of financial institutions and particularly the banking industry in America and what steps should be taken at the Federal level in order to assure a stable and responsive financial system for our Nation's future. We recognize that we do this in partnership with the States. Many of us have had extensive experience at the State level and want to assure that the dual banking system continues in the new era in which it will be operating.

Your comments today have been very helpful toward that objective.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

OVERSIGHT HEARINGS ON THE CONDITION OF THE BANKING SYSTEM

WEDNESDAY, OCTOBER 25, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Donald W. Riegle (chairman of the committee) presiding.

Present: Senators Riegle, Garn, Pressler, D'Amato, Gramm, Graham, Dixon, Bryan, and Sanford.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The Committee will come to order. Let me welcome our guests that are here today. I see some students in the back, and we are pleased to have you joining us today.

We welcome all witnesses this morning. This is the third of our hearings on the condition of the banking industry. We will hear today from the three Federal bank regulatory agencies and then from the General Accounting Office.

In light of our earlier hearings, four issues deserve particularly close attention. First, whether bank capital standards will be strong enough to protect the deposit insurance fund. Second, whether bank regulators should move more quickly to prevent failing banks from incurring large losses. Third, whether bank examinations are adequate. Fourth, whether the FDIC's Bank Insurance Fund has sufficient reserves.

The OCC and the FDIC are currently at odds over what capital standards should apply to banks once the new risk-based standards take effect. The OCC's approach would evidently allow many banks to reduce their capital, particularly banks that come out well under the risk-based standards. The FDIC and the GAO say that that would be bad policy. The OCC disagrees. And the issue obviously deserves very close attention.

In our October 5th hearing, witnesses emphasized the value of early intervention, under which regulators seek to deal with a troubled bank before it incurs a large negative net worth. In principle, it ought to be possible for regulators to deal with such a bank before it generates large losses for the deposit insurance fund. But Mr. Seidman's testimony indicates that the FDIC's losses over the last 8 years have averaged 12 cents per dollar of bank assets, and reached 31 cents on the dollar in 1987. We need to know what the agencies are doing to head off problems before they grow so large.

We also need to know how the FDIC and the OCC are planning to use the expanded early intervention powers that were given in the recent thrift bill.

Since 1975, the number of examiner hours per dollar of deposits has declined substantially at the OCC. This decline is cause for concern. As banks operate in a riskier environment, as bank operations grow more complex, and as more banks fail, it would seem that we need more examiner resources and not less.

Kenneth Littlefield, the Texas Banking Commissioner, testified last week here that examiners are behind the curve in dealing with problem banks. He said that examination and supervision should focus on leading indicators of bank problems and not on trailing indicators.

We need to hear how all three agencies are dealing with problem banks.

Finally, Robert Litan of the Brookings Institution asserted at a previous hearing that the FDIC's Bank Insurance Fund has $4 billion in reserves and not $14 billion as reported by the FDIC.

Recent press reports of bank exposure to leveraged buyouts and weak real estate markets add to our concerns about the adequacies of the FDIC's reserves. Disagreement over the size of those reserves highlights the need for more and better information. The committee and the public need to know on a regular basis how many banks are insolvent, how many are undercapitalized, how much money the FDIC estimates it will take to deal with problem institutions, and how long it will take to deal with them.

We look forward to the bank regulators addressing these issues this morning and then hearing from the GAO as well.

Let me now yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator Garn. Thank you, Mr. Chairman.

Today's panel of Federal Regulators brings together a very select group of government officials to whom we have entrusted the stewardship of the entire banking system.

The responsibilities of each of these men is enormous, and particularly it has been increased since we passed the S&L legislation this summer. Vastly increased their duties and responsibilities.

The Banking Committee will be watching their actions and reviewing their decisions even more closely than ever before, given these heightened responsibilities.

I welcome the opportunity to hear all of your testimony this morning. And, this year, Congress had to focus its attention on the problems in the savings and loan industry; potential problems in the banking system also need attention.

It is only by comparison with the savings and loan industry that the banking picture seems to rosy. Last year, the FDIC bank fund reported its first loss, officially declining by 23 percent, from $18.3 billion to $14.1 billion. Some academics and outside experts argue that even these figures are misleading.

The true level of reserves is even lower. The number of bank failures has exceeded 200 annually each year since 1987 and remains high this year as well. More disturbing expert witnesses have testified that many weak banks remain in operation despite their condition.

In the area of competitiveness, additional problems exist, as the Chairman pointed out during the hearings last week. Foreign banks are making serious inroads in our domestic markets. Japanese banks now control about 25 percent of the banking market in California and may have a quarter of the total U.S. commercial loan market by the mid-1990's.

U.S. banks also have severe competitive disadvantages with respect to European banks and these disadvantages will only become exacerbated when the European community becomes a single market in 1992.

The Congress has a responsibility to examine the powers of our domestic financial institutions and holding companies in order to assure that our institutions can effectively compete in the world market. And that this is done in a manner that does not adversely affect safety and soundness.

Yet another area that needs to be addressed is capital. Beginning in 1991, financial institutions and holding companies will have to comply with the new risk-based capital standard. This standard will be supplemented by leverage ratios. The interplay between these two capital requirements will be a critical factor in determining the safety of our financial institutions, the availability and cost of bank products and the ability of our banks to compete in the international area.

I am anxious to hear from the Federal regulators on what has become a controversial issue, as well as the testimony of the General Accounting Office, which I understand also has an opinion on this question.

Gentlemen, the Banking Committee has always had the opportunity to work closely with your agencies in the past and I am sure that we will have that spirit of cooperation and openness in the future.

It is certainly vital that we do as we monitor these difficult problems.

I also apologize. I will have to leave in about 30–40 minutes. All of you have heard of reconciliation, and there is a conference starting at 11 o'clock on reconciliation over on the House side.

So, I apologize for not being able to stay for the entire hearing.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Garn.

There are many of us on this committee who are conferees in that reconciliation, including this chairman, so we have multiple activities we have to deal with this morning.

I'm going to take whatever opening comments there are from my other colleagues, in the order in which they have arrived. I think that means Senator Pressler, that you are next in line here.

Senator **PRESSLER**. Thank you, Mr. Chairman. I have another hearing that I must attend, but I have a question for the record that I would appreciate having the Comptroller of the Currency respond to.

The **CHAIRMAN**. Very good. We will make that part of the record. Senator Mack.

Senator **MACK**. No statement.

The **Chairman**. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Mr. Chairman, let me first thank you for holding this hearing. I want to remind the gentlemen before us running the primary regulatory agencies that the decisions you are making have a great impact on the Nation, but they have a greater impact on Texas. And I want to remind you that the future of America depends on a strong and vibrant Texas in the 1990's to lead the economic recovery of the Nation.

Texas is recovering. Its recovery is fragile. It's plodding, but I am hopeful that it is about to take off and be the engine pulling the national recovery in the 1990's. And I want to remind you guys to not kill off this recovery.

It is vitally important, as I have said in visits with each of you, that we not sit on these assets that we have taken back as part of the responsibility of the Resolution Trust Corporation, that we not allow the problem to fester. But, on the other hand, it is vitally important that we have the kind of regulation and the kind of asset disposition that will let the recovery build, grow and ultimately be a source of economic expansion.

So I don't want you to be nervous, but I want you to realize that the future of the Republic depends on what you do. [Laughter.]

The **Chairman**. Senator D'Amato.

Senator D'**Amato**. I cannot top those remarks. [Laughter.] Mr. Chairman, I would ask for permission to simply submit my statement as if read in its entirety.

The **Chairman**. Very good. I also have statements from Senators Dixon and Sanford that will follow.

STATEMENT OF SENATOR D'AMATO

Senator D'**Amato**. Mr. Chairman, these are exciting times in the banking industry. The economic world of bankers today is diverse, colorful and constantly changing. Just as the "3–6–3" rule [take deposits at 3 percent, lend at 6 percent and be on the golf course at 3 p.m.] is dead in the thrift industry, the comfortable, well-secured, short-term lending of the banking industry has given way to diverse banking products, increased competition and increased risk.

We all know that banks have entered into a new world of risk management which requires far sharper judgments than the typical banking decision of the past. Corporate finance lending, commonly referred to as LBO lending, foreign development loans and real estate lending are three examples of the new riskier types of business which today's banks find themselves in. We are ever aware of the potential for peril that such developments bring, but you have to admit, Mr. Chairman, it isn't dull.

This committee has an oversight function the difficulty of which is increased by the rapidly evolving economic environment and the daily changes in the banking industry. We must continually shift our focus. We read of rising losses to Arizona banks from bad real estate loans and indications of a similar trend in parts of the northeast. Third World Debt poses a special problem in the financial centers and many believe that bank participations in leveraged buy-outs presents another risk. The oversight task can be daunting.

But in the Congress we can do more than react to events. We can legislate and I am heartened by reports that the House Banking Subcommittee on Financial Institutions may take up banking legislation in this session of the Congress. I also note growing support for the Cranston-D'Amato-Garn comprehensive banking reform bill. This is our proper function—to provide a framework for fair competition and insulation of the deposit insurance funds—and then let the cards fall where they will. Let the rewards be commensurate with the investors' risks and let all participants bring their capital to the industry. Then we will be competitive with foreign banks and our consumers will get the best service.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the condition of the banking industry. We have the distinguished Vice Chairman of the Federal Reserve Board, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the Assistant Comptroller-General of the General Accounting Office before us today. I look forward to hearing their analysis of the situation facing our banking industry, and their predictions for the future.

This is a time of record earnings for our banks, the number of bank failures is beginning to diminish, bank capital is up, and the bank deposit insurance system has been strengthened. We should be confident about the future, yet there is also reason for unease. Part of the reason has to do with continuing concerns about loan quality. Real estate, LBO's, and Third World debt are all difficult areas. Further, our banking industry faces increasing pressure from foreign competition.

I think we must face the challenges facing our banking industry. We must have reform. We must give our banks the ability to respond to the changes that have taken place in the market, and to respond to the changes that continue to occur. We need improved ways to look at risk. We need to better understand risk, what it means for our banking system, and how best to monitor it and keep it within reasonable bounds. We also need strong supervision. In this era of volatile markets, we have to have strong, effective supervision. I know that the testimony of the banking regulators and the General Accounting Office will provide us with valuable insights as we attempt to address these issues.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I appreciate your efforts in calling for this hearing and would like to welcome our panel of distinguished bank regulators.

Certainly if we learned nothing else from the FSLIC crisis, we learned that we need to examine the true condition of all our financial institutions—both federally and State chartered—before problems reach overwhelming proportions. We also learned some painful lessons about the problems that can arise when there is too great a gap between the agency who regulates the institutions and the agency providing the insurance. I am glad that we have the opportunity to hear today from some of the regulators responsible for overseeing our banking institutions.

Despite the strong position of the banks in North Carolina, I share many of my colleagues' concerns regarding the overall state of the industry—both large bank holding companies and smaller, community banks. We must ensure that our banks are strong and safe if they are to compete in today's global marketplace. In making sure that a sound banking system is in place, it is clear that we must look at the capital adequacy of all our financial institutions, the risks associated with expansion into LBO financing and continuing concerns over LDC debt, and the need to make sure that the recently enacted increase in bank premiums are sufficient to ensure a sound insurance base for our institutions.

In addition, I believe that this committee must do a better job of keeping an eye on the quality and strength of our bank examining force. I believe that a good deal of the trouble in the savings and loan industry resulted from a confusion between deregulation and desupervision. If banks are to perform a wider variety of activities and to engage in new, potentially risky activities such as LBO lending, then we must make doubly sure that our banks are carefully monitored and examined often. We need to make sure that a proper emphasis on supervision exists throughout our financial system.

Again, I thank our witnesses and look forward to their testimony.

The CHAIRMAN. Gentlemen, we appreciate having you here with us today. I would underscore the important note of cooperation that goes back between this Committee and each of you, and the operations that you run. We feel that we have very good relationships and we want to continue those, so it is very important that we think and work together. It doesn't mean we will agree on each and every thing but, generally, I think we should have and will continue to have a very good and sound working relationship with each of you.

With that, I am going to make your full testimony a part of the record in each case, and would then ask each of you if you would summarize the high points and take us to the issues that we really need to have you address orally.

And let us start with you, Chairman Seidman.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, WASHINGTON, DC

Mr. SEIDMAN. Thank you, Mr. Chairman and members of the committee. We are pleased to report on the condition of the commercial banking industry, the Bank Insurance Fund and our role as supervisor. First, addressing the condition of the industry, in summary, the banking industry's health is acceptable and is improving.

Capital levels need to be enhanced. Bank failures in the Southwest are still too high and the LDC debt remains a problem. At this time, we see nothing in 1990 raising a significant threat to the solvency of the Bank Insurance Fund.

Increased real estate lending by banks is a matter of concern and must be carefully supervised to avoid problems of concentration and risk.

We foresee some unfortunate trends in real estate in certain areas. These problems, however, do not appear to be large enough to cause substantial declines in earnings on an industry-wide basis.

Banks have had record profits for the first half of this year, earning $14.3 billion compared to $10.4 billion in the first half of 1988.

Equity capital increased $9.8 billion during the first six months of 1989, and was 6.4 percent for all banks at June 30th, the highest level in the last 6 years.

Some of the largest commercial banks added several billion dollars to their loan loss reserves in the third quarter. These additions will raise the industry's reserves about the previous record level of $50.3 billion reported in the first quarter of 1988. They will result in a break even for the third quarter and substantially lower profits for the full year when compared with a prior year.

We applaud the conservative, extra provisions recently made by some banks. However, it should be noted that money center banks would continue to be solvent even if they wrote down to current secondary market levels all their exposure to the six major LDC countries.

Capital levels in commercial banks are improving, but certainly are not excessive at this time of increasing risk to the system.

We agree with Chairman Greenspan's recent remarks to the American Bankers Association on the need for capital and its relationship to profitable operations.

He emphasized that banks do not need exceptionally low capital ratios to produce acceptable returns on equity. In the first half of this year, commercial banks retained an equity capital to assets ratio of 6.44 percent and a primary capital to asset ratio of 7.99 percent.

These are the highest ratios in recent years. This is not to say that some banks are not sorely in need of additional capital. As of September 30, 1989, the Bank Insurance Fund's problem bank list contained 1,166 institutions representing slightly less than $200 billion in deposits. Most, if not all, of these banks have inadequate capital.

This past March, the bank regulators adopted risk-based capital guidelines for years beginning in 1990. Currently, these guidelines are in addition to a 6 percent leverage ratio. The Comptroller of the Currency has suggested a new leverage ratio standard for national banks. We support important parts of the Comptroller's initiative.

We agree on the proposed 3 percent core capital requirement and the exclusion of reserves for loans and leases as a component of core capital. However, the Comptroller's proposal envisions no additional leverage requirement beyond the 3 percent care capital level.

Our analysis, which we have just completed, indicates that, under the proposal, 9,844 banks would have lower requirements.

Further, the required minimum amount of capital in the bank system as a result of these lower standards would be a reduction of $8 billion. As the insurer, we believe that capital requirements should not be lowered at this time for either the thrift or the banking industries.

The status of the Bank Insurance Fund: In 1988, the FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Provisions for insurance-related losses in 1988 were $6.3 billion. As a result, as the chairman stated, the Fund declined more than $4 billion from $18.3 billion to $14.1 billion at the end of 1988.

For the first 6 months of 1989, net income for the Bank Insurance Fund was $171 million. We expect the Fund to break even for the full year and to increase in 1990.

Moreover, we expect the number of failures to begin to decline and for this trend to continue in to 1990.

Not only has the Fund been adequate to handle the problems of the past few years, but liquidity has been maintained despite record insurance-related outlays.

At year end 1988, $16.5 billion of the Fund's assets were in cash or U.S. securities. This level, however, will be reduced to approximately $12 billion in 1989 as we meet our obligations to the Federal Reserve on Continental Illinois and pay for losses incurred.

Interest income for the Fund for 1988 amounted to $1.4 billion and a similar amount is projected for 1989. Assessment income for 1988 was $1.8 billion and our projection for 1989 is $1.9 billion. However, with increased rates, we project $3 billion in 1990 and $3.9 billion in 1991.

Bank supervision. In July of last year, we revised our statement of goals to increase the frequency of on-site examinations. Our goal, which we had anticipated reaching by 1990, is to have an on-site examination every 24 months for one or two rated institutions, and every 12 months for those rated 3, 4 or 5.

We are well along in meeting that goal in spite of our involvement since February in the thrift conservation program. In 1988, we conducted 4,019 on-site safety and soundness examinations, compared to 3,653 in 1987 and 3,194 in 1986. We expect to complete more than 4,100 examinations during 1989.

So we will exceed our 1988 level. We had expected to do even more than that, but had to revise our goal due to the conservatorship program.

We have been increasing the number of field examiners since 1984, when our examiner force numbered 1,389.

At year end 1988, the FDIC had 1,983 bank examiners. We expect this number to increase to about 2,400 by the end of 1989.

The FDIC must attract and retain the most qualified individuals to be examiners. We are studying salary levels, benefits and programs in order to retain as many of our highly trained and qualified examiners as possible.

We are able to hire very good talent due to the expedited hiring procedures for college students with a 3.5 grade point average who are in the top 10 percent of their class. This year alone, we hired 325 examiners under this expedited procedure. We are exploring with the U.S. Office of Personnel and Management the possibility of lowering the 3.5 to 3.0 in order to be able to use this program on an expanded basis.

Thrift supervision. Under the new law, the FDIC must supervise some 2,900 saving associations. We expect to have an FDIC on-site presence—either a full examination or a targeted visit in area insured savings institutions—by the end of 1990.

Our approach will emphasize coordination with the Office of Thrift Supervision and State Regulators. In conclusion, we see the condition of the banking industry improving during the next year.

I would like to take a final minute to discuss the work of Mr. Litan and Brombaugh regarding the condition of the banking industry. Originally, they claimed that the Bank Insurance Fund was overstated by $10 billion. We pointed out their data was a year old. Using more current data, they then stated that the Fund had unrecognized losses of $7 billion.

We then pointed out that the FDIC had already set aside reserves for all of the banks that they said were insolvent. This reduced their adjustment to $2 billion. The $2 billion involved future expenses and, of course, did not involve a recognition of the fact that the FDIC income would be over $4 billion in the period.

They changed their assumptions to come up with a $5 billion loss figure, which was submitted in a letter to Chairman Riegle on October 23, 1989.

The bottom line, Mr. Chairman, is that their conclusions that the industry is in worse condition than reported is not supported by their analysis, even after three tries.

We thank you very much for your attention.

[The complete prepared statement of L. William Seidman follows:]

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D. C.

ON

THE CONDITION OF THE COMMERCIAL BANKING INDUSTRY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
UNITED STATES SENATE

10:00 A.M.
OCTOBER 25, 1989
ROOM 538, DIRKSEN SENATE OFFICE BUILDING

SUMMARY OF FDIC STATEMENT

The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest is, and will remain through 1990, the region with the highest levels of problem and failed banks.

Banks in the Northeast recently have shown a declining trend in asset-quality indicators. The softening real estate market and continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets for three consecutive quarters. However, we do not see these difficulties developing into anything requiring significant FDIC financial assistance

In 1988, the FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was $171 million and we expect it to break even for the full year and to increase in 1990.

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. In the first half of 1989, commercial banks increased their equity capital by $9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. This is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. Our analysis indicates that the Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion, as compared with a risk-based capital requirement supplemented with a six percent total capital requirement. Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

Good morning, Mr. Chairman and members of the Committee. We are pleased to report today on the condition of the commercial banking industry. We also will be reporting on the condition of the Bank Insurance Fund and the status of supervision as the Federal Deposit Insurance Corporation begins to implement the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high. We have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions. All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

The three banking agencies earlier have provided you with a book of statistics on bank performance and condition, problem bank levels and trends, bank failures and assistance transactions (updated numbers for closed banks and open bank assistance by FDIC as of September 30, 1989 are included as Attachment A), number and experience level of examiners, and examination hours by CAMEL rating. We also have attached to this testimony our most recent Quarterly Banking Profile, which provides current statistics on commercial banking results.

The Economy and the Condition of the Banking Industry

The overall financial condition of the banking industry is closely tied to national and regional economic conditions. Lately, national economic conditions have been favorable, with relatively low inflation and interest rates, and moderate economic growth. The weakest regional economies have been improving, particularly in the Midwest, where the agricultural recovery has led to a strong performance by banks in that region. The Southwest economy has shown signs of recovery, but this has not yet translated into significantly improved bank performance. Most failed banks in 1988 and so far in 1989 were located in Texas, Oklahoma or Louisiana. Texas alone accounted for more than one-half of all bank failures last year; this year, Texas has accounted for two-thirds of all failures. The Southwest is and will remain the region with the highest levels of problem and failed banks, at least through 1990, but we expect overall bank performance to show improvement next year.

In contrast, banks in the Northeast recently have shown a declining trend in asset-quality indicators. A softening real estate market has boosted the level of nonperforming real estate loans. These loans and the continuing problems in loans to developing countries (which affect only the largest banks) have been primarily responsible for a rise in nonperforming assets for three consecutive quarters. These problem areas are expected to adversely impact this region's bank earnings in the second half of 1989. While some of the problems in the Northeast are now receiving public notice, we do not see these difficulties developing into anything requiring significant FDIC financial assistance.

The Northeast also is the location of most of the Bank Insurance Fund's ("BIF") insured savings banks. Since mid-1987, BIF-insured savings banks have experienced lower earnings attributable to shrinking net interest margins and rising loan-loss expenses.

Nonperforming assets of savings banks at the end of the second quarter were more than twice as high as a year earlier. Most of the problem assets were in real estate loans, which comprise the majority of state-chartered savings bank assets. As of September 30, 1989, 15 BIF-insured savings banks were on the "Problem List," representing only three percent of the industry; in contrast, nine percent of commercial banks were on the "Problem List" on that date. The number of BIF-insured savings bank failures has not exceeded two in any year since 1983. In view of the trend toward higher problem levels in real estate lending in the Northeastern United States, we expect some deterioration in these numbers in 1990.

Status of the Bank Insurance Fund (BIF) and Bank Failures and Assistance Transactions

Financial institution failures and open-bank assistance transactions were at record levels in 1988 in size, number and cost to the Insurance Fund. The FDIC handled 200 bank failures and provided financial assistance for the resolution of 21 additional institutions. Included in these numbers were the failure of First RepublicBank in Dallas and the assistance of Houston-based First City Bancorporation. Also included in the FDIC's 1988 operating losses was the commitment of funds to handle MCorp of Dallas, Texas American Bancshares of Fort Worth, and National Bancshares Corporation of San Antonio (all of which are being resolved during this year). In total, provisions for insurance-related losses in 1988 were $6.3 billion. As a result, the net worth of the Insurance Fund declined more than $4 billion, from $18.3 billion to $14.1 billion at year-end 1988.

Even though the number of bank failures has remained high during 1989, with 170 failures as of October 13, provisions for losses are down significantly. For the first six months of 1989, net income for the Bank Insurance Fund was $171 million and we expect it to about break even for the full year and to increase in 1990. Moreover, we expect the number of failures to begin to decline and for this trend to continue into 1990. The number of problem banks has been dropping for over two years, from a high of 1,624 in mid-1987 to 1,166 as of September 30, 1989, and this favorable trend is beginning to show up in the failed-bank numbers.

Not only has the Fund been adequate to handle the bank problems of the past few years, but liquidity has been maintained despite record insurance-related outlays. At year-end 1988, nearly 74 percent of the Fund's total assets, or $16.5 billion, was in the form of cash or U.S. Treasury securities and this level has been maintained during 1989. New approaches to dealing with bank failures and aggressive management of assets held for liquidation have been responsible.

Several provisions in FIRREA provide the FDIC with additional flexibility to help ensure that the Bank Insurance Fund can effectively address future problems in the industry. Insurance premiums will increase to 12 basis points of assessable deposits in 1990, and to 15 basis points in 1991. We estimate that with a modest four percent annual growth rate in assessable deposits, assessment income will be about $3 billion in 1990 and $3.9 billion in 1991. This compares to $1.8 billion in 1988 and a projected $1.9 billion in 1989. In addition, the FDIC has the flexibility to increase these rates based upon the experience of the Fund. The FDIC will continue to earn interest on the portfolio of U.S. Treasury securities held in the Fund. Interest income for 1988 amounted to $1.4 billion and a similar amount is projected for 1989. The increased statutory assessment rates and the flexibility to change those rates should allow the Bank Insurance Fund to attain and then maintain the 1.25 percent target ratio of the Fund to insured deposits.

The FDIC ended 1988 with 106,000 assets in liquidation with a book value of $9.3 billion. The assets were acquired from failed and assisted institutions. This was a significant decline from the past three years when at year-end 1987 we held 178,000 assets with a book value of $11.3 billion; at year-end 1986 we held 192,000 assets with a book value of $10.9 billion; and, in 1985, we held 180,000 assets with a book value of $9.6 billion. This reduction can be attributed to the success of our "whole bank" purchase and assumption program where the acquirer purchases most of the assets of the failed bank.

With respect to the assets retained by the FDIC, strong marketing and asset management has resulted in significant asset sales at or near current appraised values. Our policy is that every asset is for sale at the appraised market price. Getting these assets back into the private sector at market prices is the first step in helping troubled regional economies recover.

Our testimony now will focus on the seven specific questions raised in the Committee's letter of invitation.

1. Are you satisfied that commercial banks and their holding companies have enough capital to protect the public interest and avoid a future crisis at the Bank Insurance Fund?

Capital levels in commercial banks are adequate and improving, but certainly not excessive at this time of increasing risks to the system. We agree with Chairman Greenspan's recent remarks before the American Bankers Association regarding the role of capital. He emphasized that banks do not need exceptionally low capital ratios to produce an acceptable return on equity and that strong capital ratios do not preclude strong returns.

In the first half of this year, commercial banks increased their equity capital by $9.8 billion and have attained an equity capital-to-assets ratio of 6.44 percent and a primary capital-to-assets ratio of 7.99 percent. These are the highest industry-wide capital ratios in recent years. Large banks in particular have steadily increased their equity capital as a percentage of total assets, aided by strong earnings and prompted by new risk-based capital requirements.

That is not to say that some banks are not sorely in need of additional capital. The supervisors are working closely with those banks to overcome the problem, where possible. As of September 30, 1989, the Bank Insurance Fund's problem bank list contained 1,166 institutions representing slightly less than $200 billion in deposits. Most, if not all, of these banks are deemed to have inadequate capital.

Fortunately, most problem banks are rehabilitated, usually with close supervisory guidance. For example, in 1988, only about one third of the 680 banks that were removed from the problem list were removed as a result of failure or FDIC financial assistance.

Now is not the time to be reducing capital standards. The banking business is an increasingly volatile one and well known concerns remain in areas such as interest rate risk, concentrations, real estate volatility and loans to lesser developed countries.

The Comptroller of the Currency has suggested a change to the leverage capital standard which has been in place for several years. While important parts of the Comptroller's initiative have merit and my support, the issue ultimately boils down to, "Now is not the time to lower capital requirements." Our analysis indicates that the Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion, as compared with a risk-based capital requirement supplemented with a six percent total capital requirement. While most of the largest U.S. banks will be subject to a risk-based capital requirement that will be higher for them than a leverage ratio (as of the risk-based capital phase-in dates of year-end 1990 and 1992), the vast majority of U.S. banks will continue to be governed by the six percent leverage ratio which is uniformly in place at all three banking agencies. Lowering the leverage ratio to just three percent core capital with no additional requirement will allow many financial institutions which currently exceed the six percent ratio to suddenly have large amounts of "excess capital" available to fund growth and/or reduce capital through dividends or in other ways. We estimate that almost 10,000 banks would be able to reduce their equity capital under the Comptroller's proposal, as compared with a six-percent total capital requirement.

As the insurer of the industry, we would regard that as being an undesirable effect. Thus, we believe the three percent core leverage test must be supplemented with a total capital requirement which could include secondary forms of capital such as those allowed under the current leverage framework. We support limiting or eliminating the allowance for loan losses in this calculation.

Common capital standards among the three Federal banking agencies have been beneficial to the industry as well as the insurance fund. We believe that acceptable common standards must be adopted before the risk-based standards first begin to apply at year-end 1990.

2. Are you confident that earnings reported for the banking industry reflect the true earnings performance of the industry?

Commercial banks' net income totalled $14.3 billion for the first six months of 1989, the most ever earned in a six-month period. This record level of earnings is attributable to the performance of the largest banks which have seen a dramatic rise in earnings due to improved net interest income, strong gains in noninterest income, and reduced loan loss expenses.

However, increasing problems in real estate loans in soft markets and continuing problems with loans to lesser developed countries are expected to be main factors influencing bank earnings in the second half of 1989 and beyond. At the end of June, the banking industry's loss reserves totalled just over $45 billion, an amount equal to 62.6 percent of its nonperforming assets.

Recently published earnings reports indicate that some of the largest commercial banks added several billion dollars to their loan-loss reserves in the third quarter. These additions will raise the industry's reserves above the previous record level of $50.3 billion reported in the first quarter of 1988. This boosting of reserves will be accomplished at the expense of industry earnings for the third quarter, and may produce a net drop in commercial banks' combined equity capital. In this respect, the large banks' additions to loss reserves are similar in nature, albeit much smaller in scale, to their $15-billion reserve boost in the second quarter of 1987. That boost, too, was made in response to perceived changes in the value of the banks' loans to developing countries. It represented a restructuring of their balance sheets, and resulted in a more accurate portrayal of their net worths. The latest additions to reserves will mean that subsequent reported earnings will more closely represent banks' "true" earnings performance. Our concerns regarding LDC lending and investments in real estate are discussed below.

In summary, bank earnings appear adequate to provide for the foreseeable losses in the banking industry and provide the support needed for capital growth.

3. Do you have any concerns about the portfolio composition (particularly investments in real estate, LBOs and LDC lending) of banks and their holding companies?

It is a supervisor's job to worry about all the risks that banks take on, including those arising from how they structure their balance sheet. As such, this is an area which receives a lot of our attention through off-site monitoring, special reviews and, of course, the regular examination process. The three areas raised in this question, along with interest rate risk, are matters of some concern in regards to banks' portfolio composition.

Lesser Developed Countries (LDC) Debt. The regulatory agencies have required that specific reserves be established against certain exposures to LDC debt. The agencies also have required increased capital in several banks involved in international lending. These requirements are regularly reviewed by an interagency committee composed of specially trained examiners. Because all the major U.S. banks have been able to reduce their relative exposures to LDC debt through increased capital and reserve levels, reductions, and write-offs, the risks to the banking system have been reduced significantly even though protracted problems in the LDC arena continue.

We believe that decisions on reserving for losses should be determined by each individual borrower's debt service capacity. For those banks intending to dispose of LDC loans, higher reserves could be appropriate, based on secondary market values. Thus, we applaud the conservative, extra provisions recently made by some banks. Future actions in this area will depend upon the results of current negotiations now underway with debtor countries.

It should be noted that all the money-center banks would continue to be solvent even if they wrote down to current secondary-market levels all their exposures to the six major LDC countries.

Real Estate. Domestic real estate loans is the fastest growing item on commercial banks' balance sheets, increasing to a total of $720 billion in outstandings as of June 30, 1989, or 36.2 percent of total loans. This amount is 12.8 percent higher than the same time last year. This growth has been most pronounced in the largest institutions.

This rapid growth gives us some concern, as would a similar rapid growth in any other asset category. Rapid growth is usually accompanied by a decrease in credit quality, and indeed we have begun to notice an increase in nonperforming real estate assets, including repossessed real estate, principally in the Northeast. It should be pointed out, however, that the Southwest banks still have the highest percentage of nonperforming assets, principally in real estate, with a rate that is over twice as high as the Northeast's.

We are monitoring the level and quality of real estate portfolios closely. While we foresee some unfavorable trends in real estate asset losses and charge-offs, the extent of these problems are not great enough to cause uncontrollable losses or substantial declines in earnings on an industry-wide basis. some states permit bank investment in real estate. In all banks the dividing line between a loan with an "equity kicker" and a direct investment can be blurred. We believe banking institutions can safely and profitably invest in real estate, but that it generally should be done through non-bank subsidiaries and affiliates. We continue to seek regulatory means to create such a requirement.

Leveraged Buyout Financing (LBOs). LBOs or the more encompassing term "highly leveraged transactions" (HLTs) (which also includes recapitalization and acquisition financing) are a concern because of the volume and rapid growth of such transactions in the banking industry, especially at the largest institutions. Banks currently have invested over $175 billion in HLT loans. We must point out though that the originating banks generally do not keep all HLT loans in their portfolios. Instead, they sell participations to others without recourse and retain only a small percentage of a transaction.

We are taking special supervisory action by monitoring banks' participation in HLTs very closely. We believe that to date, banks have managed their HLT financing risks acceptably. Of course, rising interest rates or an economic downturn could increase these risks, but we do not now see any serious threats to the banking industry.

4. Are you satisfied that bank examinations are being carried out in an effective and timely fashion?

Today's banking environment demands that we identify emerging trends and potential areas of risk and pinpoint individual banks with symptoms of higher than normal risk. The traditional methods of conducting on-site examinations based on fixed examination cycles have given way to more continuous methods of supervision. Our current program uses on-site examinations and visitations complemented with off-site monitoring, exchanges of information with other regulators (state and federal), and the use of supervisory guidelines, policy statements, and rules and regulations.

Our experience in recent years has indicated the need to increase the level and frequency of on-site supervision. As a result, in July of last year we revised our statement of goals regarding examination priorities. Our goal is to have an on-site examination every 24 months for well-rated institutions (those rated 1 or 2) and one every 12 months for problem and near-problem institutions (those rated 3, 4, or 5). The intervals for those rated 1, 2, or 3 can be extended if an acceptable state examination is conducted.

In 1988, we conducted 4,019 on-site safety-and-soundness examinations compared to 3,653 in 1987 and 3,194 in 1986. We expect to complete more than 4,100 examinations during 1989. We had expected to do considerably more than 4,100 this year, but had to revise that goal due to our involvement as conservator for insolvent thrifts. Even with that additional role, we will still exceed last year's examination tally.

As of June 30, 1989, over 90 percent of the 4- and 5-rated state nonmember banks had undergone an FDIC examination, visitation, or state examination within the preceding twelve-month period. The others are monitored closely, already have supervisory corrective action in place and, in most cases, have been examined within the last two years.

Also, as of June 30, 1989, only two percent of all 1- and 2-rated state nonmember banks have not had an FDIC or acceptable state examination or visit within the last three years. This percentage has been declining for some time now and we expect this trend to continue.

We have increased examiner hours spent on examinations of state nonmember banks from 1.3 million hours in 1985 to over 2.2 million hours in 1988. Most of this increase has been on banks rated 1 and 2, from 532,000 hours to over 1.2 million hours. In addition, those banks rated 3, 4, and 5 receive considerable review and processing by regional office and Washington office staff.

5. What is your record with regard to initiating and accomplishing your goals for enforcement actions?

The FDIC seeks corrective action from all institutions presenting supervisory concerns. Depending on the seriousness of the problem and the willingness and ability of management to effect correction, we may use an informal Memorandum of Understanding or we may proceed with formal action pursuant to Section 8 of the FDI Act. Attachment B describes the various types of enforcement powers available to the FDIC. It also includes a brief review of the circumstances which generally have led to the use of such actions.

During the period January, 1984 through March 31, 1989, 2,072 state nonmember banks had been considered "Problem Banks" and another 1,905 state nonmember banks were rated a composite 3 and considered a supervisory concern, although their possible failure was considered to be only a remote possibility. Seventy-four percent or 2,953 institutions were subject to some form of FDIC enforcement action. In most cases, the close supervisory attention afforded these institutions led to their rehabilitation. Only 448 or 11 percent of those banks failed or required FDIC financial assistance. Forty-four percent or 1,762 institutions improved their condition or merged with a stronger institution, and 1,767 or 44 percent remained in the "problem bank" (4- or 5-rated) or 3-rated categories. Attachment C provides a summary of the "problem bank" performance.

Enforcement actions, both as to type and scope, are tailored to the particulars of each problem situation. Our goal is to obtain correction using the most appropriate degree of intrusion. The FDIC believes that its enforcement actions are effective, especially in cases where bank management is cooperative and desirous of working together with the regulators to restore their institution to financial stability. The Capital Forbearance Program and the use of Agricultural Loan Loss Deferral are examples of this approach which have proven both useful and beneficial to the FDIC and participating banks. The basic goals and philosophy of these programs have long been used by the FDIC in our enforcement program.

However, whenever fraud, mismanagement, or insider abuse is present, the FDIC has not, and will not, hesitate to use its enforcement powers to the fullest. The new powers granted to us in FIRREA will allow us to increase our enforcement actions in such cases, especially in regards to individuals. We believe that fraud losses and unjust gains to insiders should be restored to institutions and to the federal deposit insurance funds wherever possible. The FDIC is working with the Department of Justice to convince judges to order restitution to the insurance funds when losses are attributed to dishonest insiders or customers. We think restitution orders should be sought and granted as a matter of course to minimize the cost of criminal acts to the insurance funds and to prevent offenders from enjoying their ill-gotten gains.

6. What is your forecast of the condition of the banking industry for the next year?

Generally, we see the condition of the banking industry improving during the next year. The declining trend in the number of problem banks should continue and we expect the number of failed banks to decline from the record levels of 1988 and 1989, both in size and number. The Southwest will continue to be the region of the country with most of the problems, although all of the largest commercial bank problems in that region have been restructured. We expect overall bank performance in that region to show a slight improvement next year, but recovery will be slow due to that region's overbuilt real estate markets. Banks in the Northeast probably will show some declining trends due to problem real estate loans in that area's regional banks and also due to the fact that most of the large banks which are involved in LDC lending are located in that area of the country.

It has been suggested by others that the banking industry is much weaker than our analysis indicates. The analysis prepared by Mr. Litan and Mr. Brumbaugh and presented by Mr. Litan before this Committee concludes that ten percent of the industry's assets are in institutions that have less than a three percent capital ratio. However, our recent analysis is that less than one-half of a percent have less than a three percent capital ratio. Our response to their statement is provided as Attachment D.

7. What is your plan of action for remedying any concerns you have?

With respect to the adequacy and liquidity of the Bank Insurance Fund, we plan to continue to pursue "whole bank" purchase-and-assumption transactions whenever possible and to continue aggressive marketing of assets held for liquidation. The increase in premiums will allow the Fund to grow and substantial progress should be made toward the 1.25 percent target reserves-to-insured deposits ratio.

We will continue to stress a strong supervisory approach as one of our major responsibilities. We are the primary federal supervisor for over 8,000 state nonmember commercial and savings banks with over $900 billion in assets. In addition, we monitor the condition of approximately 5,500 national and state member banks and approximately 2,900 savings and loans, and cooperate with the other federal and state regulatory authorities in their efforts to ensure the safe and sound operation of these insured institutions. A major goal of the FDIC's supervisory program is to control risk and to anticipate problems to the extent possible. The concerns mentioned above will continue to receive special close supervisory attention and we are prepared to take whatever corrective enforcement action may be necessary if bank management is not otherwise responsive.

This supervisory program will need to be as effective and timely as possible. We intend to increase the number of examiners to about 2,400 by the end of 1989 and to hire even more during 1990. This will allow us to conduct even more examinations. We are building a new training facility and are committed to the maintenance of a well trained examiner force. In 1989 we expect to spend $11.2 million on examiner training, an amount equal to almost 10 percent of total examiner compensation. We think that this is money well spent.

It is imperative that the FDIC attract and retain the most qualified individuals to be examiners. We are studying salary levels, benefits and programs intended to enhance job satisfaction in order to retain as many of our highly trained and qualified examiners as possible. Further, we are able to hire very good talent due to an expedited hiring procedure available with respect to college students who have a 3.5 grade point average or who are in the top ten percent of their class. This year alone we hired 325 examiners under this expedited procedure. We are exploring with the U.S. Office of Personnel Management the possibility of lowering the 3.5 GPA minimum in order to increase the number of candidates available to us under this program.

Also, as noted, we intend to pursue bank fraud, mismanagement and insider abuse wherever found and to take all appropriate supervisory action against both individuals and institutions. We are working closely with law enforcement authorities to see that these matters are pursued to the fullest extent possible.

Thrift Supervision

FIRREA has assigned the FDIC substantial responsibilities for the supervision of some 2,900 savings associations. In addition to deposit insurance and general backup enforcement responsibilities, the FDIC also has responsibility for overseeing several important thrift activities -- such as the exercise of nontraditional powers, the holding of junk bonds and the acquisition of brokered funds.

In order to assure that these responsibilities are fully and properly addressed, we expect to have an FDIC on-site presence, either a full scale examination and/or targeted visit(s), in every insured savings association by the end of 1990. Our approach will emphasize coordination and close working relationships with the Office of Thrift Supervision and state regulators with the goal being timely and effective supervision of savings and loans and the avoidance of duplication of effort on the part of the various regulatory agencies.

We will fulfill our new thrift industry responsibilities, but only with extraordinary efforts and some start-up strains. We also intend to meet those responsibilities without material impact on our supervisory role on the commercial bank side.

That concludes my prepared remarks. I would be happy to respond to any questions at this time.

The FDIC Quarterly Banking Profile

L. William Seidman, Chairman

Second Quarter 1989

COMMERCIAL BANKING PERFORMANCE —SECOND QUARTER 1989

- ***Bank Earnings Remain Strong — First-Half Earnings Highest Ever***
- ***Banks Boost Net Worth Ratio to Pre-1987 Level***
- ***Asset Quality Problems Move East***
- ***Southwest Banks Register Loss, But Turnaround May Be Imminent***
- ***Number of Problem Banks Reaches Lowest Level in Three Years***

Commercial banks earned $7 billion in the second quarter, down from the $7.3 billion earned in the first quarter, but 30.7 percent above the $5.4 billion earned in the second quarter of 1988. For the first six months of 1989, industry net income totalled $14.3 billion, the most ever earned in a six-month period. Equity capital increased by $9.8 billion during that period, with $4.6 billion added during the second quarter. Asset quality showed some overall improvement, as nonperforming assets ended the first half below the level of a year ago, but regional trends were mixed. In a reversal of recent experience, nonperforming asset levels fell in the three regions west of the Mississippi River, and rose in the three eastern regions.

Continuing improvement in net interest income, strong gains in noninterest income, and reduced loan-loss expenses were key factors in the record earnings results. Earning assets were only 4.8 percent higher than a year earlier. Growth was led by real-estate loans, up 12.8 percent from a year ago, and consumer loans, up 6.0 percent. Funding shifted slightly from deposits, up 4.1 percent year-to-year, to nondeposit liabilities, up 7.1 percent. With interest rates mostly stable during the second quarter, smaller banks were able to increase their net interest margins over first-quarter levels. Larger banks' margins remained essentially unchanged.

Chart A — Quarterly Net Income of FDIC-Insured Banks, 1985—1989

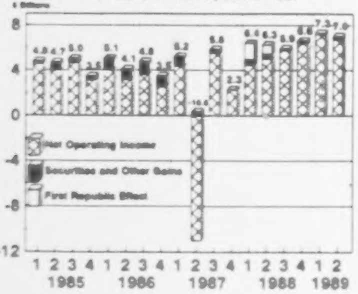
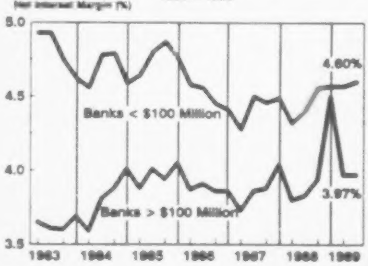


Chart B — Quarterly Net Interest Margins 1983—1989



Banks' aggregate loan-loss reserves have declined in each quarter after peaking in the first quarter of 1988. Large banks in particular have steadily increased their equity capital as a percentage of total assets, aided by strong earnings and prompted by new risk-based capital requirements. Because of this, the growth in the industry's equity capital has more than offset a decline in loss reserves, so that the cushion of equity and reserves has increased relative to nonperforming assets.

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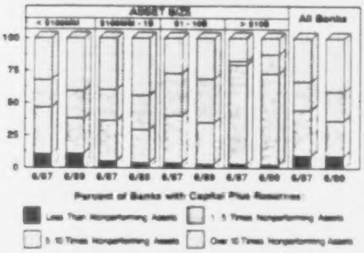
The increase in nonperforming assets in the eastern regions has come from troubled loans to developing countries and real estate. The 20 percent write-down of loans to Argentina that was mandated in the second quarter was the main reason that banks in the Northeast and Central regions had a higher quarterly charge-off rate than in the second quarter of 1988. Banks in the other four regions had lower charge-off rates than a year earlier. The decline in asset quality has been greatest in the Northeast region, with banks in the Central and Southeast regions reporting only slight increases in the percentage of nonperforming assets. The Northeast was the only region to show a year-to-year increase in the proportion of banks losing money.

Chart C — Distribution of Banks by Problem Asset Coverage Levels and Asset Size June 1987 & June 1989

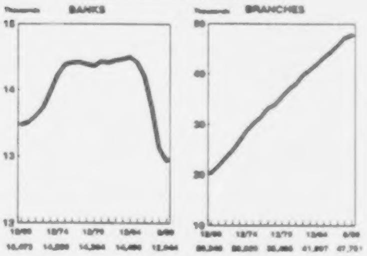


Recent trends in Southwest bank performance suggest that the prolonged deterioration of that region's banking sector may have finally ended. The improvement in asset-quality indicators in the Southwest region is especially encouraging, even though much of the improvement is attributable to FDIC intervention in failure and assistance transactions in recent years. Second-quarter net charge-offs were almost two-thirds lower than a year earlier, and nonperforming assets declined by 27.6 percent. The percentage of banks with earnings losses has been declining in recent quarters. Southwest banks still have the highest percentage of nonperforming assets, more than twice the national average, as well as the highest percentage of banks on the FDIC's "Problem List."

The number of commercial banks fell during the quarter, as the industry continues the consolidation process begun in 1985. The 12,944 banks operating at the end of June was a record low since the creation of the FDIC in 1934. A continued high rate of bank failures, a lower rate of new bank charters, and conversion of multibank holding company subsidiaries into branches have contributed to reducing the number of commercial banks. Despite this shrinkage, the total number of banking offices has continued to grow.

In the first six months of 1989, 101 banks failed or received assistance to avert failure, the same number as in the first half of 1988. For the second half of 1989, the failure rate is expected to moderate, with the average asset size of failed institutions well below the average for failed banks in 1988. This expectation is based on the continuing decline in the number of "problem" banks since midyear 1987. The 1,256 commercial banks on the "Problem List" is the fewest since June 1986.

Chart D — Numbers of FDIC-Insured Commercial Banks & Branches, 1969—1989



The outlook for bank performance in the remainder of 1989 is clouded by uncertainties as to the earnings impact of the recently completed Mexican debt restructuring. The outlook for other developing-country loans remains problematic. The continuing rapid expansion of domestic real-estate loan portfolios, in the face of rising nonperforming rates in some areas, may portend more losses ahead. The recent economic climate, characterized by positive economic growth and low interest-rate levels, has been largely favorable for asset quality. Any adverse changes in these conditions could exacerbate current asset problems and trigger losses, especially in commercial credits extended in highly-leveraged transactions. At this point it is uncertain whether full-year earnings will exceed the all-time record of $25.1 billion earned last year.

Chart E — Percent of Banks on "Problem List" by Region, June 1987 & June 1989

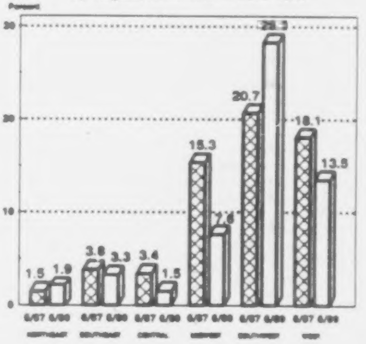


Table I. Selected Indicators, FDIC-Insured Commercial Banks

	1989*	1988*	1988	1987	1986	1985	1984
Return on assets	0.91%	0.89%	0.83%	0.12%	0.63%	0.70%	0.65%
Return on equity	14.22	11.35	13.37	2.00	9.94	11.31	10.73
Equity capital to assets	6.44	6.15	6.28	6.04	6.20	6.20	6.15
Primary capital ratio	7.99	7.86	7.85	7.70	7.22	6.91	6.91
Nonperforming assets to assets	2.25	2.39	2.14	2.46	1.94	1.87	1.97
Net charge-offs to loans	0.87	1.00	0.99	0.92	0.98	0.84	0.76
Asset growth rate	4.95	4.92	5.88	2.01	7.71	8.86	7.11
Net operating income growth	47.98	N/M	1666.92	-85.27	-20.66	6.30	3.40
Percentage of unprofitable banks	9.72	13.46	14.44	17.66	19.79	17.09	13.06
Number of problem banks	1,256	1,456	1,394	1,559	1,457	1,098	800
Number of failed/assisted banks	101	101	221	201	144	118	78

*Through June 30; ratios annualized where appropriate   N/M—Not meaningful

Table II. Aggregate Condition and Income Data, FDIC-Insured Commercial Banks

(dollar figures in millions)

	Preliminary 2nd Qtr 1989	1st Qtr 1989	2nd Qtr 1988	%Change 88:2-89:2
Number of banks reporting	12,944	13,003	13,411	-3.5
Total employees (full-time equivalent)	1,544,594	1,526,179	1,536,763	0.5
CONDITION DATA				
Total assets	$3,207,318	$3,150,604	$3,055,956	4.9
Real estate loans	719,640	695,032	638,107	12.8
Commercial & industrial loans	612,341	604,348	599,454	2.1
Loans to individuals	379,152	371,494	358,256	5.8
Farm loans	31,048	28,729	30,617	1.6
Other loans and leases	246,958	247,327	256,422	-3.7
Total loans and leases	1,989,139	1,946,929	1,883,077	5.6
LESS: Reserve for losses	45,065	45,891	49,306	-8.6
Net loans and leases	1,944,074	1,901,037	1,833,771	6.0
Temporary investments	478,735	484,320	467,712	2.4
Securities over 1 year	394,640	386,505	387,746	1.8
All other assets	389,869	378,741	366,728	6.3
Total liabilities and capital	3,207,318	3,150,604	3,055,956	4.9
Noninterest-bearing deposits	455,846	440,200	463,096	-1.6
Interest-bearing deposits	1,997,018	1,988,462	1,893,216	5.5
Other borrowed funds	420,674	399,338	391,125	7.6
Subordinated debt	17,684	17,360	17,206	2.8
All other liabilities	109,568	103,339	103,438	5.9
Equity capital	206,527	201,916	187,875	9.9
Primary capital	256,227	251,671	240,967	5.9
Nonperforming assets	72,052	69,503	72,901	-1.2
Loan commitments and letters of credit	849,830	837,726	813,634	4.4
Domestic office assets	2,788,717	2,736,044	2,638,775	5.7
Foreign office assets	418,601	414,560	417,181	0.3
Domestic office deposits	2,129,564	2,103,810	2,027,190	5.0
Foreign office deposits	323,311	324,852	329,122	-1.8
Earning assets	2,817,449	2,771,863	2,689,228	4.8
Volatile liabilities	1,138,678	1,118,089	1,070,838	6.4

INCOME DATA	Preliminary First Half 1989	First Half 1988	%Change	Preliminary 2nd Qtr 1989	2nd Qtr 1988	% Change
Total interest income	$155,511	$129,460	20.1	$80,177	$65,751	21.9
Total interest expense	99,326	78,095	27.2	51,945	39,722	30.8
Net interest income	56,185	51,365	9.4	28,232	26,029	8.5
Provision for loan losses	7,983	9,203	-13.3	4,383	4,589	-4.5
Total noninterest income	24,544	22,144	10.8	12,829	11,131	15.3
Total noninterest expense	52,850	50,080	5.5	26,977	25,218	7.0
Applicable income taxes	5,965	4,791	24.5	2,981	2,424	23.0
Net operating income	13,932	9,415	48.0	6,720	4,930	36.3
Securities gains, net	212	534	-60.3	161	142	13.0
Extraordinary gains, net	178	436	-59.1	148	306	-51.8
Net income	14,322	10,385	37.9	7,028	5,378	30.7
Net charge-offs	8,529	9,298	-8.3	5,053	5,305	-4.8
Net additions to capital stock	314	347	-9.4	114	144	-20.5
Cash dividends on capital stock	6,675	6,086	9.7	3,504	2,906	20.6

Table III. First Half Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution				Geographic Distribution					
						EAST			WEST		
	All Banks	Less than $100 Million	$100 Million to $1 Billion	$1-10 Billion	Greater than $10 Billion	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
FIRST HALF Preliminary *(The way it is . . .)*											
Number of banks reporting	12,944	10,081	2,487	336	40	1,094	1,958	2,884	3,064	2,446	1,498
Total assets	$3,207.32	$371.76	$588.54	$1,042.86	$1,204.36	$1,275.86	$457.76	$519.79	$207.44	$258.06	$488.42
Total deposits	2,452.86	329.09	503.67	773.54	846.57	913.66	362.54	413.37	164.39	216.41	382.51
Net income *(in millions)*	14,322	1,668	2,808	4,401	5,445	5,515	2,224	2,768	1,150	84	2,580
Percentage of banks losing money	9.7%	11.0%	5.3%	5.9%	2.5%	8.8%	9.5%	3.4%	4.6%	21.8%	13.7%
Percentage of banks with earnings gains	64.9%	62.6%	73.1%	72.3%	65.0%	71.2%	67.1%	68.0%	58.5%	59.0%	72.0%
Performance Ratios (annualized)											
Yield on earning assets	11.25%	10.49%	10.79%	11.05%	11.91%	11.89%	10.80%	10.61%	10.92%	10.15%	11.39%
Cost of funding earning assets	7.18	5.90	6.15	6.74	8.56	8.28	6.53	6.61	6.43	6.59	6.15
Net interest margin	4.06	4.59	4.64	4.31	3.36	3.61	4.27	4.00	4.49	3.56	5.24
Net noninterest expense to earning assets	2.06	2.75	2.63	2.21	1.36	1.67	2.37	2.03	2.03	2.31	2.83
Net operating cash flow to assets	1.77	1.88	1.81	1.86	1.70	1.69	1.69	1.76	2.21	1.06	2.25
Net operating income to assets	0.88	0.88	0.96	0.84	0.89	0.87	0.97	1.06	1.10	0.03	1.00
Return on assets	0.91	0.91	0.97	0.86	0.92	0.88	0.99	1.09	1.13	0.07	1.08
Return on equity	14.22	10.07	12.98	13.66	17.99	14.61	14.18	15.89	14.68	1.12	17.85
Net charge-offs to loans and leases	0.87	0.64	0.62	0.87	1.05	0.90	0.46	0.67	0.93	1.77	0.96
Loan loss provision to net charge-offs	93.59	123.10	123.09	119.07	61.03	74.51	138.57	92.65	117.98	98.29	108.61
Condition Ratios											
Loss allowance to:											
Loans and leases	2.27%	1.67%	1.57%	1.73%	3.26%	2.64%	1.32%	1.89%	1.96%	2.56%	2.54%
Noncurrent loans and leases	74.19	72.27	75.52	85.75	69.56	68.97	96.28	99.15	94.56	44.66	83.50
Nonperforming assets to assets	2.25	1.92	1.77	1.58	3.16	2.52	1.12	1.29	1.59	4.75	2.57
Equity capital ratio	6.44	9.06	7.56	6.35	5.16	6.06	7.02	6.89	7.82	5.84	6.15
Primary capital ratio	7.99	9.96	8.53	7.51	7.53	7.90	7.88	8.16	9.02	7.07	8.18
Net loans and leases to deposits	79.26	59.41	71.50	86.77	84.73	84.97	78.76	74.34	73.09	59.63	86.15
Growth Rates (year-to-year)											
Assets	4.9%	5.8%	9.5%	11.1%	4.1%	4.6%	9.5%	6.8%	0.8%	-4.7%	7.5%
Equity capital	9.9	5.3	9.3	12.0	14.3	11.7	9.7	8.7	4.7	2.8	14.0
Net interest income	9.4	11.9	16.9	15.2	6.6	8.1	10.3	10.1	4.4	-1.2	17.2
Net income	37.9	22.3	18.8	10.4	1.5	-3.9	9.1	6.8	7.0	N/M	49.5
Nonperforming assets	-1.2	3.3	16.4	24.6	3.1	13.0	15.3	13.2	-8.6	-27.6	-7.4
Net charge-offs	-8.3	1.7	17.9	-7.2	16.2	45.8	-17.6	-3.3	-29.5	-53.6	-6.4
Loan loss provision	-13.3	2.6	17.8	30.5	5.9	12.6	13.3	16.8	-2.7	-63.9	23.4
PRIOR FIRST HALVES *(The way it was . . .)*											
Return on assets 1986	0.69%	0.72%	0.78%	0.69%	0.64%	0.96%	0.99%	1.09%	1.06%	-2.08%	0.77%
1985	0.68	0.75	0.85	0.75	0.49	0.80	1.10	0.93	0.77	-0.06	0.26
1984	0.63	0.97	0.92	0.73	0.22	0.63	0.99	0.25	0.93	0.82	0.47
Equity capital ratio 1986	6.15	8.78	7.36	6.20	4.58	5.67	7.01	6.76	7.53	5.41	5.80
1985	6.33	8.65	7.23	6.16	5.03	5.83	6.80	7.02	7.53	6.92	5.57
1984	6.07	8.86	7.16	5.82	4.41	5.39	6.79	6.45	7.86	7.01	5.38
Nonperforming assets to assets 1986	2.39	2.07	1.81	1.72	3.36	2.33	1.07	1.21	1.75	6.26	2.99
1985	2.03	2.37	1.90	1.59	2.33	1.59	1.03	1.52	2.44	3.57	3.16
1984	1.70	0.86	0.84	1.46	2.86	1.70	0.86	1.79	1.10	1.52	2.89
Net charge-offs to loans and leases 1986	1.00	0.75	0.74	1.16	1.08	0.85	0.62	0.75	1.40	3.40	1.09
1985	0.84	1.16	0.79	0.80	0.81	0.57	0.50	0.80	1.81	1.53	1.12
1984	0.61	0.59	0.48	0.56	0.72	0.33	0.32	1.00	0.89	0.93	0.77

REGIONS: Northeast — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont
Southeast — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia
Central — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin
Midwest — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
Southwest — Arkansas, Louisiana, New Mexico, Oklahoma, Texas
West — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming

Table IV. Second Quarter Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution				Geographic Distribution					
						EAST			WEST		
	All Banks	Less than $100 Million	$100 Million to $1 Billion	$1-10 Billion	Greater than $10 Billion	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
SECOND QUARTER Preliminary *(The way it is . . .)*											
Number of banks reporting	12,944	10,081	2,487	336	40	1,094	1,958	2,864	3,064	2,446	1,498
Net income	7,028	801	1,401	2,036	2,790	2,788	1,132	1,381	541	-34	1,222
Percentage of banks losing money	10.4%	11.8%	5.8%	6.3%	5.0%	9.3%	10.3%	3.8%	5.5%	22.4%	14.5%
Percentage of banks with earnings gains	61.9%	59.6%	69.9%	72.3%	62.5%	64.7%	62.1%	65.4%	57.7%	57.8%	68.4%
Performance Ratios *(annualized)*											
Yield on earning assets	11.49%	10.88%	10.99%	11.29%	12.20%	12.16%	10.95%	10.83%	11.28%	10.45%	11.60%
Cost of funding earning assets	7.45	6.06	6.34	6.98	8.89	8.59	6.71	6.83	6.72	6.93	6.37
Net interest margin	4.05	4.80	4.66	4.31	3.31	3.58	4.23	4.01	4.56	3.51	5.23
Net noninterest expense to earning assets	2.03	2.74	2.63	2.20	1.33	1.88	2.33	1.95	2.15	2.28	2.57
Net operating cash flow to assets	1.77	1.89	1.82	1.87	1.69	1.88	1.70	1.84	2.16	1.06	2.28
Net operating income to assets	0.85	0.84	0.96	0.77	0.87	0.83	0.97	1.08	1.05	-0.11	0.95
Return on assets	0.89	0.87	0.95	0.79	0.93	0.88	1.00	1.08	1.07	-0.05	1.02
Return on equity	13.78	9.58	12.78	12.45	18.20	14.58	14.28	15.64	13.80	-0.91	16.58
Net charge-offs to loans and leases	1.03	0.74	0.68	0.94	1.38	1.19	0.51	0.74	0.92	1.92	1.04
Loan loss provision to net charge-offs	86.75	118.68	116.96	127.50	48.95	59.54	132.08	93.86	118.08	108.28	113.69
Growth Rates *(year-to-year)*											
Net interest income	8.5	10.5	15.0	14.3	5.8	7.0	9.5	9.2	4.8	-2.1	16.0
Net income	30.7	20.2	20.5	2.8	2.8	-5.6	13.9	8.8	-1.8	N/M	49.7
Net charge-offs	-4.8	3.2	5.1	-14.7	46.8	102.1	-2.0	9.4	-32.0	-64.2	-20.4
Loan loss provision	-4.5	4.6	9.6	31.9	6.5	18.3	3.0	32.3	-9.8	-52.9	30.3
PRIOR SECOND QUARTERS *(The way it was . . .)*											
Return on assets 1988	0.71%	0.67%	0.75%	0.67%	0.74%	0.97%	0.98%	1.06%	1.08%	-1.79%	0.73%
1986	0.60	0.63	0.80	0.80	0.32	0.77	1.09	0.90	0.77	-0.15	-0.04
1984	0.56	1.00	0.94	0.74	-0.02	0.61	1.04	-0.25	0.94	0.84	0.54
Net charge-offs to loans and leases 1988	1.14	0.89	0.93	1.38	1.10	0.63	0.57	0.73	1.41	4.75	1.40
1986	0.97	1.45	0.94	0.86	0.92	0.64	0.56	0.86	2.06	1.93	1.28
1984	0.77	0.69	0.63	0.72	0.93	0.41	0.37	1.48	0.89	0.97	0.94

NOTES TO USERS

COMPUTATION METHODOLOGY FOR PERFORMANCE AND CONDITION RATIOS

All income figures used in calculating performance ratios represent amounts for that period, annualized (multiplied by the number of periods in a year).

All asset and liability figures used in calculating performance ratios represent **average** amounts for the period (beginning-of-period amount plus end-of-period amount plus any periods in between, divided by the total number of periods).

All asset and liability figures used in calculating the condition ratios represent amounts as of the end of the quarter.

DEFINITIONS

"Problem" Banks—Federal regulators assign to each financial institution a uniform composite rating, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" banks are those institutions with financial, operational or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either "4" or "5".

Earning Assets—all loans and other investments that earn interest, dividend or fee income.

Yield on Earning Assets—total interest, dividend and fee income earned on loans and investments as a percentage of average earning assets.

Cost of Funding Earning Assets—total interest expense paid on deposits and other borrowed money as a percentage of average earning assets.

Net Interest Margin—the difference between the yield on earning assets and the cost of funding them, i.e., the profit margin a bank earns on its loans and investments.

Net Noninterest Expense—total noninterest expense, excluding the expense of providing for loan losses, less total noninterest income. A measure of banks' overhead costs.

Net Operating Income—income after taxes and before gains (or losses) from securities transactions and from nonrecurring items. The profit earned on banks' regular banking business.

Net Operating Cash Flow—pre-tax net operating income before the provision for loan and lease losses, a measurement of banks' cash flow, net of interest and overhead expenses, from regular operations. Previously referred to as "adjusted net operating income".

Return on Assets—net income (including securities transactions and nonrecurring items) as a percentage of average total assets. The basic yardstick of bank profitability.

Return on Equity—net income as a percentage of average total equity capital.

Net Charge-offs—total loans and leases charged off (removed from balance sheet because of uncollectibility) during the quarter, less amounts recovered on loans and leases previously charged off.

Nonperforming Assets—the sum of loans past-due 90 days or more, loans in nonaccrual status, and noninvestment real estate owned other than bank premises.

Noncurrent Loans & Leases—the sum of loans past-due 90 days or more and loans in nonaccrual status.

Primary Capital—total equity capital plus the allowance for loan and lease losses plus minority interests in consolidated subsidiaries plus qualifying mandatory convertible debt (cannot exceed 20 percent of total primary capital), less intangible assets except purchased mortgage servicing rights.

Net Loans and Leases—total loans and leases less unearned income and the allowance for loan and lease losses.

Temporary Investments—the sum of interest-bearing balances due from depository institutions, federal funds sold and resold, trading-account assets and investment securities with remaining maturities of one year or less.

Volatile Liabilities—the sum of large denomination time deposits, foreign office deposits, federal funds purchased, and other borrowed money.

Requests for copies of and subscriptions to the FDIC Quarterly Banking Profile should be made through the FDIC's Office of Corporate Communications, 550 17th Street N.W., Washington, D.C. 20429; telephone (202) 898-6996.

TABLE 1
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
FDIC INSURED INSTITUTIONS
BY SIZE (000 Omitted)

Year-End	0 - $300 Million		$300 - $1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
9-30-89	149	$8,760,154	11	$6,069,582	3	$11,988,038	163	$26,817,774
1988	205	10,249,691	10	6,089,863	6	37,482,000	221	53,821,554
1987	198	6,497,955	4	1,739,120	1	1,236,000	203	9,473,075
1986	142	5,008,665	2	1,061,013	1	1,616,816	145	7,686,494
1985	118	3,049,848	1	413,948	1	5,277,472	120	8,741,268
1984	77	2,371,211	2	905,200	1	35,900,000	80	39,176,411
1983	45	2,344,397	1	778,434	2	3,904,092	48	7,026,923
1982	33	954,850	6	4,139,841	3	6,537,724	42	11,632,415
1981	7	103,626	1	899,029	2	3,856,405	10	4,859,060
1980	10	236,164			1	5,500,000	11	5,736,164
1979	10	132,988					10	132,988
1978	6	281,495	1	712,540			7	994,035
1977	6	232,612					6	232,612
1976	15	627,186	2	762,107			17	1,389,293
1975	13	419,950					13	419,950
1974	3	166,934			1	3,655,662	4	3,822,596
1973	5	43,807			1	1,265,868	6	1,309,675
1972	1	22,054			1	1,300,000	2	1,322,054
1971	7	205,820					7	205,820
1970	7	62,147					7	62,147

Source: FDIC Annual Reports

Attachment A

TABLE 4

CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC

FDIC INSURED INSTITUTIONS

BY REGIONS (000 Omitted)

Year-End	NORTHEAST		SOUTHEAST		CENTRAL		MIDWEST		SOUTHWEST		WEST	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
9-30-89	3	$1,304,975	4	945,878			8	$84,002	136	$24,323,894	12	$1,059,025
1988	2	630,665	3	749,856	7	$ 164,110	29	525,484	157	49,909,066	23	1,842,373
1987	5	2,015,091	6	293,322	7	160,795	40	603,194	110	5,042,844	35	1,357,829
1986	1	31,785	7	916,960	5	83,395	48	1,111,849	54	4,790,073	30	752,432
1985	4	5,878,941	9	291,368	4	60,243	50	902,512	31	913,844	22	684,360
1984	2	912,066	16	575,892	10	36,149,902	22	316,185	14	593,534	16	628,832
1983	4	2,686,460	13	1,735,776	7	222,858	5	97,984	5	1,539,623	14	744,222
1982	8	8,130,668	7	360,994	7	122,018	4	1,078,399	13	1,217,370	3	722,766
1981	3	4,755,434	1	7,621	2	73,060					4	22,943
1980	2	5,505,732	4	115,084	1	8,794	4	106,554				
1979	1	12,681	4	74,742	2	24,809	1	5,038	1	10,659	1	5,059
1978	2	721,892	3	18,851	2	253,292						
1977	2	194,569	1	24,223			1	5,509	2	8,311		
1976	6	640,558	2	452,182	1	507			5	233,382	3	62,664
1975	2	26,285	1	18,049	4	330,875	2	10,474	3	28,610	1	5,657
1974	1	3,655,662	1	147,137	1	16,295	1	3,502				

Attachment A

Generally, the Corporation's authority for formal enforcement actions emanates from Section 8 of the Federal Deposit Insurance Act. These include termination of deposit insurance, issuance of cease and desist actions (including immediate temporary actions), suspension or removal of a bank officer or director, or prohibition of participation by others in bank affairs when certain criteria can be established. The initiation of formal actions is based upon findings of practices or conditions deemed unsafe or unsound (undesirable, unacceptable and/or objectionable) and/or violations of law, regulation, condition or order.

The circumstances which lead to the taking of formal enforcement actions can include unsatisfactory management, inadequate capital, failure to recognize or charge off losses, inadequate loan valuation reserve, unsatisfactory loan administration, large volume of subquality assets, operating losses or inadequate earnings, unwarranted dividends or other insider payments, poor liquidity, lacking or insufficient corporate planning, failure to file or inaccurate reports, and/or violations of laws and regulations. Actions may require institutions to cease unsatisfactory practices, take affirmative action to correct deficiencies, and/or achieve and maintain certain acceptable levels in the future. Civil money penalties are assessed to punish the violator and to deter future violations. They may be issued for violations of several laws and are initiated if the violation is found to be willful, flagrant, or otherwise evidence bad faith on the part of the bank or individual(s), and/or if violations have not been corrected or represent repeat-type violations. [redacted]

Memorandums of understanding or FDIC Resolutions with a bank's board of directors are considered for near-problem banks and are used by the FDIC as a means of applying informal action to institutions of supervisory concern, but which have not deteriorated to the point where they warrant formal administrative action. They may also be utilized in otherwise deteriorated situations where, because of strong commitment for correction on the part of a competent board and management, more formal action is foregone. Contents of a resolution memorandum are uniquely fashioned to address the specific problems of an individual institution.

The Capital Forbearance Policy is for solvent and viable banks with concentrations in weak economic sectors that are experiencing a severe, unexpected and protracted downturn. These banks have had their capital deficiency caused by external problems in the economy that are beyond management's control. Situations are such that these banks are not able to raise additional needed capital. The FDIC is not enforcing capital standards on the banks approved into this program. These banks have provided an acceptable plan for capital restoration, have competent management, and file annual progress reports.

Each of the FDIC's Regional Offices has front-line responsibility to identify and recommend institutions or individuals for formal or informal enforcement actions (most commonly through examination or visitation reports). The senior staff meets directly with an institution's board of directors to delineate deficiencies and seek appropriate corrective measures. The Regional Office staff will monitor and follow up on compliance with provisions of formal or informal enforcement actions through reviewing progress reports required to be submitted at specified intervals by the institution and first-hand appraisals by Corporation field examiners at subsequent examinations and visitations.

Attachment B

ADMINISTRATIVE ACTIONS

The Board of Directors of the FDIC uses a broad array of enforcement powers, including:

Section 8(a) - Termination of Insurance - The most severe sanction available to the FDIC is the termination of a bank's insurance (national banks, Federal savings banks and many state banks are not permitted to operate without federal deposit insurance). Insurance termination may be used where the FDIC determines that a bank is in an unsafe or unsound condition or has violated a law or regulation. In practice, insurance termination is generally reserved for banks whose financial condition has seriously deteriorated and other efforts to obtain correction have failed.

Section 8(b) - Cease and Desist Proceedings - Permits the FDIC to order an insured bank and its directors, officers, employees, and agents to cease and desist from certain practices and violations and take affirmative action to correct the condition resulting therefrom.

Section 8(c) - Temporary Cease and Desist Proceedings - Provides that the FDIC may issue a Temporary Cease and Desist Order whenever the FDIC determines the violation or threatened violations or unsafe or unsound practices are likely to cause insolvency or substantial dissipation of assets or earnings of the bank, seriously weaken the condition of the bank, or otherwise seriously prejudice the interests of the depositors prior to the completion of action under Section 8(b).

Section 8(e) - Removal Procedures - Gives the FDIC the power to remove any director, officer, or other person participating in the conduct of the affairs of a bank for certain conduct evidencing personal dishonesty and posing a threat to the bank or its depositors.

Section 8(g) - Suspension Procedures - Permits the FDIC to suspend any director, officer, or other person participating in the conduct of the affairs of a bank if such person is indicted for a felony involving personal dishonesty or breach of trust.

Attachment B

Section 8(p) - Termination of Insurance - Permits the FDIC to terminate the insurance of an insured banking organization that is not engaged in the business of receiving deposits, other than trust funds.

Civil Money Penalties - Fines assessed by the FDIC on banks, bank officers, directors, and/or persons participating in the conduct of a bank's affairs because of violations of certain laws, regulations, or cease and desist orders.

Part 325 Capital Directive - Final order issued by the FDIC to a bank that fails to maintain capital at or above the minimum capital requirement as set forth by Part 325 of the FDIC Rules and Regulations.

Memorandums of Understanding and Board Resolutions - Informal agreements between the FDIC and the bank's board of directors which are used in banks of supervisory concern but which have not deteriorated to the point where formal administrative action is warranted.

Capital Forbearance - Formal agreements to give undercapitalized institutions time to recapitalize. These are supported by a written plan discussing the bank's plans for operating in a safe manner and their intentions and timetable for increasing capital.

Attachment B

PROBLEM BANK PERFORMANCE
January, 1984 to March, 1989

	# Banks	%
3, 4, or 5-rated during period	3,977	100%
"Problem Bank" during period	2,072	52%
Subject to enforcement action (1)	2,953	74%
Failed or required assistance	448	11%
3, 4, or 5-rated as of March 31, 1989	1,767	44%
Improved or merged	1,762	44%

(1) - Includes formal and informal actions.

Attachment C

Response to the Joint Congressional Testimony of
R. Dan Brumbaugh and Robert E. Litan

Introduction:

In their article entitled 'Cleaning Up the Depository Institutions Mess' published in the Brookings Papers on Economic Activity, 1:1989, and in testimony before the Senate Banking Committee and the House Subcommittee on Financial Institutions, R. Dan Brumbaugh and Robert E. Litan suggest that the banking industry is much weaker than official reports indicate. They contend that, while the banking industry is generally sound, the existence of a sizeable number of insolvent and thinly capitalized institutions indicates that 'actual' bank insurance fund reserves are far less than officially reported. From their analysis as of September 1988, Mr. Litan and Mr. Brumbaugh assert that one-third of the industry's assets were being managed by banks with sub-standard capital ratios. From these findings they concluded that actual FDIC year-end 1988 reserves were closer to $4 billion, rather than the reported $14.3 billion.

An updated version of their analysis using March 1989 data was presented to the Senate Banking Committee on October 5, 1989. In their testimony Mr. Litan and Mr. Brumbaugh stated that they found 31 large banks with $22 billion in assets that were open but insolvent as of March 1989. In addition, they assert that 30 banks with assets of $9.3 billion had risk-adjusted capital ratios of 3 percent or less, and another 130 institutions with $929 billion in assets had risk-adjusted capital ratios of less than 6 percent. In other words, Mr. Litan and Mr. Brumbaugh claim that roughly $1 trillion of assets, or almost one-third of industry assets were held by banks with capital ratios of less than 6 percent. In their calculation of risk-adjusted capital ratios, the authors state that they followed the Basle guidelines with one exception: capital was defined as shareholder's equity (common, preferred and retained earnings) and subordinated debt. Loan loss reserves were not included in their definition of capital.

In an attempt to determine the extent of the exposure to the bank insurance fund, Mr. Litan and Mr. Brumbaugh applied a 26 percent loss ratio to assets in institutions they determined were insolvent, stating that 26 percent is the average loss ratio for the FDIC throughout the 1980s. A 10 percent loss ratio was applied to assets held in thinly capitalized institutions (those with capital ratios between zero and three percent), by reasoning that there is some likelihood that a portion of this group will become eventually insolvent. In doing so, they suggest that the bank insurance fund is about $7 billion weaker than official year-end 1988 reports. (The authors attribute about $6 billion of this loss to insolvent institutions and about $1 billion to probable failure of the thinly capitalized banks in the industry).

Attachment D

In their testimony before the House Subcommittee on September 19, 1989, Mr. Litan and Mr. Brumbaugh stated that the insurance fund was overstated by $10 billion at year-end 1988 (about $6 billion attributable to insolvencies, and about $4 billion attributable to undercapitalized banks). In that testimony, the authors referred to their analysis based on September 1988 data. At that time, Mr. Litan and Mr. Brumbaugh asserted that fifty banks with $45 billion in assets had risk-adjusted capital ratios between zero and three percent. When the analysis was updated using March 1989 data, Mr. Litan and Mr. Brumbaugh found that total assets in undercapitalized institutions (zero to three percent risk-adjusted capital) fell by some $36 billion. As of March 1989, the authors found only about $9 billion in assets in thirty undercapitalized institutions. Thus, their loss estimate regarding undercapitalized banks fell from $4 billion to about $1 billion, simply because more current data was used.

Evaluation of the Litan/Brumbaugh Analysis:

Table 1 illustrates the differences in the FDIC's analysis and the Litan/Brumbaugh assessment of the capital position of large banks in the industry as of March 1989. The results of this analysis show that, for large banks in the industry as of March 1989, 11 institutions with $2.7 billion in assets, less than one-tenth of one percent of industry assets were in insolvent institutions operating without resolution from the FDIC. One-quarter of one percent of industry assets, were in institutions that had less than a 3 percent capital ratio, while about 10 percent of industry assets were in institutions with capital ratios of between 3 percent and 6 percent.

The major difference between the Litan/Brumbaugh analysis and the FDIC assessment appears to be in the treatment of off-balance sheet items in the largest banks in the industry. The FDIC's assumptions regarding the extent of off-balance sheet activity by these large banks is in substantial agreement with a similar analysis conducted by the Federal Reserve.

In an attempt to relate the capital position of the industry to the level of reserves in the bank insurance fund, Mr. Litan and Mr. Brumbaugh make two crucial errors in arriving at the conclusion that fund balance is overstated by roughly $7 billion (a balance of $7.3 billion rather than $14.3 billion).

. Their first error comes in determining the average cost-to-failed-bank-asset ratio for the FDIC during the 1980s. The authors arrived at a 26 percent average loss ratio through 1987, indicating in their article in the Brookings Papers that the average fluctuated widely, from a low of 10 percent in 1981 and 1985, to a high of 75 percent in 1982 and 1984. This is simply not the case. In fact, between 1980 and 1988, the FDIC's weighted average loss-to-asset ratio was 12 percent, registering a low of 10.4 percent in 1985, and peaking at 31.3 percent in 1987.

In addition, Mr. Litan and Mr. Brumbaugh fail to take into account that the majority of the insolvencies present in the industry were in the process of being resolved, and that reserves had already been established to account for the cost associated with these resolutions. Therefore, because the year-end 1988 bank insurance fund balance reflects the cost of resolving most of the March 1989 insolvencies, the $6 billion figure Mr. Litan and Mr. Brumbaugh associate with resolving these institutions is a significant overstatement. If the actual average loss figure of 12 percent were applied to the $2.7 billion of assets we find in insolvent institutions, the resolution costs would be about $320 million, rather than the figure of $6 billion advanced by the authors. Applying their 10 percent loss ratio to the assets in institutions falling in the zero to three percent capital range results roughly $1 billion in additional potential losses to the FDIC.

However, as the authors themselves point out, it is reasonably likely that these thinly capitalized banks will eventually become insolvent and require FDIC resolution. Given that assumption, it would seem reasonable to expect that the failure of these institutions would occur probably within the next one-to-two years. The cost of resolving these failures will be offset by the fund's additional premium and investment income earned in those years. FIRREA provides for significant increases in assessment income so that the bank insurance fund will be sufficiently capitalized to handle future problems in the industry. Assuming a modest 4 percent annual growth rate in insured deposits, projections for 1990 and 1991 alone show that income from assessments will be almost $3 billion and $3.9 billion respectively. Premium income will continue to increase until the fund reaches the target level of 1.25 percent of insured deposits. Even if the aforementioned losses were incurred by the FDIC next year, the bank insurance fund would still show a net gain in reserves. Thus, any analysis of future FDIC loss exposure should be balanced with a discussion of increasing premium income.

Mr. Litan and Mr. Brumbaugh suggest that their analysis underestimates the problems of insolvency and undercapitalization in the industry, because they have examined only those institutions with at least $50 million in assets. We do not find that to be the case. Banks with assets of less than $50 million account for less than 8 percent of total industry assets. Therefore, as Table 2 illustrates, including small banks does not substantially change the analysis, nor does it substantially add to the potential costs to the FDIC. Table 2 presents the capital position of the entire industry, using the risk-adjusted standards (excluding allowances), and updates the analysis by providing data as of mid-year 1989.

Based on risk-adjusted capital standards using data as of June 30, 1989, less than one-half of one percent of total industry assets are held in institutions with less than 3 percent capital; only 10.3 percent of total industry assets are held in institutions with capital ratios of 6 percent or less. With respect to insolvent institutions, the addition of the small banks in the industry boost assets by about $1.5 billion by adding another 41 institutions.

TABLE 1

RISK-ADJUSTED CAPITAL POSITION OF BANKS WITH AT LEAST $50 MILLION IN ASSETS AS OF MARCH 1989

(assets in billions of dollars)

FDIC ANALYSIS

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	11*	$2.7**	(0.1%)	$2.7	(0.1%)
0 - 3%	35	9.1	(0.3%)	11.8	(0.4%)
3 - 6%	113	325.2	(9.9%)	335.0	(10.3%)
> 6%	5380	2,612.9	(89.7%)	2,947.9	(100.0%)

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* Excludes 22 banks with $18.7 billion in assets that have been resolved by the FDIC.

** Includes 3 banks with $416 million in assets that are solvent on a GAAP basis.

LITAN/BRUMBAUGH ANALYSIS

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	31	$22.1	(0.7%)	$22.1	(0.7%)
0 - 3%	30	9.1	(0.3%)	31.4	(1.0%)
3 - 6%	130	928.7	(30.8%)	960.1	(31.8%)
> 6%	5,380	2,055.5	(68.1%)	3,015.6	(100.0%)

TABLE 2

CAPITAL POSITION OF THE BANKING INDUSTRY
AS OF JUNE 30, 1989

CAPITAL RATIO	NUMBER OF BANKS	ASSETS ($ billions)		CUMULATIVE ASSETS ($ billions)	
< 0%	52*	$4.2**	(0.1%)	$4.2	(0.1%)
0 - 3%	106	8.6	(0.3%)	12.8	(0.4%)
3 - 6%	245	314.3	(9.9%)	327.4	(10.3%)
> 6%	12,489	2,860.8	(89.7%)	3,188.2	(100.0%)

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* Excludes 52 banks with $19.4 billion in assets that have been resolved by the FDIC.

** Includes 12 banks with $2.6 billion in assets that are solvent on a GAAP basis.

The CHAIRMAN. Mr. Johnson, we would be pleased to hear from you now.

STATEMENT OF MANUEL H. JOHNSON, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. JOHNSON. I welcome the opportunity to be here to present the views of the Federal Reserve on the condition of the nation's banking system.

The last several years have been turbulent ones for U.S. banks. Although its problems have been far less than those of the thrifts, the banking industry is only now emerging from a difficult period in which historically large numbers of banks have failed. It is important as we go forward that we remain vigilant in our supervisory efforts to ensure that the banking system continues to rebuild its strength and maintain the confidence of the general public.

In my remarks today, I will provide the Board's views of the general strength and outlook for the U.S. banking industry. I will also discuss some of the actions the Board has taken to foster a sounder, more resilient, and competitive banking system. I would like to begin first with an overview of current banking conditions.

An important theme when describing the recent performance of the banking industry is that many institutions have made progress toward increasing their profitability and also their reserves and capital base. The pace of improvement may be slower than we would like, bank failure rates continue to be unacceptably high, and clear pockets of real and potential problems do remain. Several large institutions, in particular, are reporting third-quarter losses due to asset quality problems that, in some cases, will give them losses for the year. Nevertheless, the industry seems to be better prepared to deal with its problems now than it has been in several years.

The current condition of the industry reflects in large part the length and nature of the current business cycle. Although we are currently benefitting from the longest peace time expansion in U.S. history, it has not been felt equally by all sectors of the economy. In particular, the energy and agricultural sectors, foreign loans, and real estate markets have presented banks with substantial problems that, in varying degrees, remain today.

Other factors, such as technological changes, financial innovations, and increased competition, have also altered the environment for at least the major banking institutions. The pace of mergers and acquisitions has also increased, due to both the large number of bank failures and interstate banking compacts. Overall, these structural changes should help U.S. banks compete in world markets by increasing their financial strength and operating efficiencies. They may also, however, present banks with additional challenges and risks. As banking regulators, we need to monitor this restructuring carefully to ensure that it is done prudently and that it leads to a stronger banking system.

Let me now turn to more specific indicators of the industry's recent performance. With the exception of third-quarter results of some of the largest banking organizations, these measures have generally shown improvement in recent periods. Earnings, for instance, of the U.S. banking industry rebounded strongly during 1988. Average return on assets during 1988 for all insured commercial banks was .8 percent, the industry's highest reported figure in decades. Importantly, the strongest performance was reported by many of the largest banks, which were responsible for the industry's losses in 1987, and which have the greatest need to strengthen their capital positions. Their 1988 results, however, reflected loan loss provisions that were significantly lower than in recent years.

For most institutions, this relatively strong earnings performance has continued into 1989 as well. During the first half of the year, both the largest banks and the banking industry reported annualized average returns on assets of about .9 percent. Until most recently, most of the improvements since 1987 have reflected sharply lower loan loss provisions by the largest institutions. However, that situation changed sharply in the third-quarter, as some of them made large loss provisions, mostly for real estate and foreign loans.

Although these losses will temper the progress that much of the industry has made, they have led to large reserves that should give these companies greater flexibility to deal with their problems. In some cases, the losses have also been coupled with plans to issue additional common stock.

Asset quality remains the principal concern facing the industry. Loans to some highly indebted countries continue to undermine the near-term earnings and competitive positions of some of the largest organizations, although that threat has been reduced with this latest round of provisions. Also, real estate loans remain a significant concern.

Real estate markets in New England, parts of the Southeast, and broad areas of the Southwest show the most visible signs of weakness and have produced some large third quarter losses. Relative to total assets, the volume of non-performing assets for the industry has increased during the first half of 1989, after declining during 1988 and remains especially high for some of the larger banking organizations.

Exposure to highly leveraged borrowers, if not properly managed, could present problems for some companies. This is clearly another area that warrants close attention by bank managers and supervisors alike.

An important indicator of the strength of the banking system is the measure of capital adequacy, which has improved. The average primary capital ratio, for example, for bank holding companies has increased from 7.9 percent at the end of 1987 to 8.25 percent at mid-year 1989. The general improvement has been widespread. We also estimate that about 94 percent of all commercial banks now meet the risk-based standard, as defined for the end of 1992.

U.S. banking system has made substantial progress toward reducing its exposure to developing countries in recent years, but some significant risks do remain. The Board generally views the third-quarter provisions as a positive development toward strengthening the banking system. However, banks would be even stronger if they continued efforts to improve the quality of their related credits. Such efforts should induce banks to work with the most credible borrowers and the international institutions to further improve the economies of these countries and their ability to service their debts.

The number and size of failing banks remains high, with 160 banks with assets of almost $26 billion failing through September 1989. The number and assets in problem institutions also remained historically and unacceptably high, but appear to have peaked. At the end of the third quarter, 1,166 commercial banks were considered problem institutions compared with a high of 1,575 banks at the end of 1987. Most of them are located in the Southwest, while conditions in the West and mid-west have actually improved.

The Federal Reserve, often in cooperation with other federal bank regulatory agencies, has adopted a number of significant measures in recent years to address real and potential risks in banks. We have also provided significant examination resources to help identify and resolve insolvent thrifts.

One of the most significant supervisory achievements in recent years has been the development of an international risk-based capital standard and the rigorous application of current primary and total capital standards. Much of the Board's influence in this area results from administering the bank holding company application process. When deciding the request of banking organizations to merge with or acquire other institutions, the Federal Reserve has and will continue to require applicants to raise additional shareholder funds, when necessary. This process will involve prohibiting poorly capitalized institutions from expanding through mergers and acquisitions and may require others to strengthen their financial positions, as well. In that way, the structural changes occurring within the industry can lead to a stronger banking system.

The Federal Reserve has undertaken a number of other noteworthy initiatives to improve the safety and soundness of the banking system and its ability to compete. They include revising and strengthening its examination guidelines on highly leveraged financings and expanding the domestic underwriting activities of bankholding companies. It has also taken important steps to reduce the overall level of U.S. payments system risk and more accurately assign this risk to the private sector users of payment services.

In summary, Mr. Chairman, these past few years have been difficult times for the banking industry and significant problems do remain. However, the performance of most institutions during 1988 and for the first part of this year suggest that progress has been made. We must see further gains though before we can say that the problems that have beleaguered the industry are in fact behind us.

Thank you.

The CHAIRMAN. Thank you very much, Vice Chairman Johnson.

[The complete prepared statement of Manuel H. Johnson follows:]

For Release on Delivery
10:00 a.m. E.D.T.
October 25, 1989

Statement by

Manuel H. Johnson

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

October 25, 1989

SUMMARY OF TESTIMONY BY THE FEDERAL RESERVE BOARD ON THE CONDITION OF THE BANKING SYSTEM

The last several years have been especially turbulent ones for U.S. banks. Although its problems have been far less than those of thrifts, the banking industry is only now emerging from a difficult period in which historically large numbers of banks have failed.

An important theme when describing the recent performance of the banking industry is that many institutions have made progress toward increasing their profitability and also their reserves and capital base. The pace of improvement has been slow, bank failure rates continue to be unacceptably high, and clear pockets of real and potential problems remain. Several large institutions, in particular, are reporting third-quarter losses due to asset quality problems that, in some cases, will give them losses for the year. Nevertheless, the industry seems to be better prepared to deal with its problems now than it has been in several years.

The current condition of the industry reflects in large part the length and nature of the current business cycle. Although we are currently benefitting from the longest peacetime expansion in U.S. history, it has not been felt equally by all sectors of the economy. In particular, the energy and agricultural sectors, foreign loans, and real estate markets have presented banks with substantial problems that, in varying degrees, remain today.

Profitability. Earnings of the U.S. banking industry rebounded strongly during 1988 and have continued, for most institutions, into 1989, as well. Average return on assets during 1988 for all insured commercial banks was 0.80 percent, the industry's highest reported annual figure in years. During the first half of 1989, the industry reported an annualized average return on assets of about 0.90 percent. Until most recently, much of the improvement since 1987 has reflected sharply lower loan loss provisions by the largest institutions. However, that situation changed sharply in the third-quarter of this year, as some of them made large loss provisions, mostly for real estate and foreign loans.

Although these losses will temper the progress that much of the industry has made, they have led to larger reserves that should give these companies greater flexibility to deal with their problems. In some cases the losses have also been coupled with plans to issue additional common stock.

Asset quality. Asset quality remains the principal concern facing the industry. Loans to developing countries and real estate loans, especially in New England and the Southwest, remain of significant concern. At more than $100 billion, the industry's loans and commitments to highly leveraged borrowers could also present problems for some companies, if not properly managed.

Capital adequacy. The industry's primary capital ratio has increased from 7.9 percent at the end of 1987 to 8.25 percent at mid-year 1989. The general improvement has been widespread.

The preponderance of small- and medium-sized institutions now meet the proposed 1992 risk-based standard, and most large institutions also meet or are well on their way toward meeting that future minimum standard.

Problem and failed institutions. Through September 1989, 160 commercial banks failed, with total assets of $25.7 billion. The number and assets of problem institutions also remain historically and unacceptably high, but appear to have peaked. At the end of the third quarter, 1,166 commercial banks were considered problem institutions, compared with a high of 1,575 banks at the end of 1987. Most of them are located in the Southwest, while conditions in the West and Midwest have improved.

Conclusion. Overall, much of the industry has made progress during the past year and one-half to rebuild earnings and capital and to compete effectively. An important feature of this effort has been the industry's trend toward consolidation, brought about by mergers or acquisitions of failed institutions and the existence of interstate compacts. These mergers may benefit individual institutions and could also lead to a stronger and more competitive banking system. It could also, however, present some companies with new and expanded risks. While the condition of the industry may have improved, we must see further gains before we can say that the problems that have beleaguered the industry are behind us.

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I welcome the opportunity to be here today to present the views of the Federal Reserve about the condition of the nation's banking system. During the last several years, the U.S. financial system has had to operate in an environment characterized by rapid change that has led to significant pressures on many institutions. The landmark legislation that Congress recently enacted to deal with the savings and loan industry is a visible illustration of the problems that certain segments of our depository institutions industry have encountered in recent times. Although the problems of the U.S. banking system have been far less than those of thrifts, the banking industry is only now emerging from a difficult period in which historically large numbers of banks have failed. It is important as we go forward that we remain vigilant in our supervisory efforts to ensure that the banking system continues to rebuild its strength and maintain the confidence of the general public.

In my remarks today I will provide the Board's views of the general strength and outlook for the U.S. banking industry and of the principal issues that we face. I will also discuss some of the actions the Board has taken to foster a sounder, more resilient, and competitive banking system. In the process, I will generally address the areas cited in the

Committee's invitation letter. I would like to begin with an overview of current banking conditions.

OVERVIEW

An important theme when describing the recent performance of the banking industry is that many institutions have made progress toward increasing their earnings and strengthening their reserves and capital base. The pace of improvement may be slower than we would like, bank failure rates continue to be unacceptably high, and clear pockets of real and potential problems remain. Moreover, some large institutions, in particular, are reporting third-quarter losses due to asset quality problems that will give many of them losses for the year. Nevertheless, the industry seems to be better prepared to deal with its problems now than it has been in several years.

The progress--and the problems--that the industry has seen reflect in large part the length and nature of the current business cycle. Although we are currently benefitting from the longest peacetime expansion in U.S. history, it has not been felt equally by all sectors of the economy. The energy sector has been hurt severely by lower oil prices; the agricultural sector has been buffeted at times by low commodity prices and at other times by poor crop yields; conditions abroad have adversely affected the quality of many foreign loans and the strength of export markets; and the volatility of interest and exchange rates has increased the risks in many business sectors. These events have also contributed to excess supplies of real estate properties in some regions of the country that, at times, have produced sharp declines in real estate values. Those declines have not only created severe problems for many thrifts, but they have also affected some banks.

Technological change, financial innovations, and increased competition have also altered the environment for at least the major banking institutions. Foreign institutions, for example, have continued to increase their market share of U.S. business loans. Some of those foreign institutions have had lower capital standards and broader powers, providing them with a competitive edge. Many of the larger U.S. banking organizations have addressed this challenge, in part, by expanding their so-called "off-balance sheet" activities, such as interest rate swaps and financial guarantees, and by devoting more energy to developing new financing techniques. They have also requested--and received--somewhat broader powers so that they can continue to compete with both nonbank firms and foreign banks.

The growing movement toward interstate banking has further altered the competitive environment for U.S. banks. The number of mergers and acquisitions of major financial institutions has increased sharply in recent years due to the failure of some large institutions and to the adoption of regional interstate compacts by many states. In general, these structural changes should help U.S. banks compete in world markets by increasing their financial strength and operating efficiencies. It may also, however, present them with additional challenges to implement the organizational and operating changes they need in order to manage their risks effectively. As banking regulators, we need to monitor these developments carefully in the months and years ahead as the industry continues to revise its structure and as we resolve the insolvent S&Ls.

RECENT FINANCIAL PERFORMANCE

Let me now turn to more specific indicators of recent banking industry performance. In general, these measures have shown an improvement in recent periods, especially for the regional institutions which are less exposed to heavily indebted foreign countries.

Profitability. Earnings of the U.S. banking industry rebounded strongly during 1988. Average return on assets during 1988 for all insured commercial banks was 0.80 percent, compared with 0.11 percent in 1987. This recent performance represented the highest reported profitability measure for the industry in decades. Importantly, the strongest performance was reported by many of the largest banks, which were responsible for the industry's losses in 1987 and which have the greatest need to strengthen their capital positions. The 25 largest bank holding companies, for example, reported a return on assets for 1988 of 0.90 percent, mostly reflecting the earnings of their subsidiary banks. Their 1988 results, however, reflected loan loss provisions that, as a percent of assets, were significantly lower than they had been in recent years.

For many institutions, last year's relatively strong earnings performance has continued into 1989, as well. During the first half of the year, both the largest banks and the banking industry reported annualized average returns on assets of about 0.90 percent. Most recently, however, some of the largest institutions have substantially increased their provisions for loan losses, which will temper the earnings gain that much of the industry has made.

Much of the earnings improvement last year reflected sharply lower loan loss provisions by the largest institutions, but other factors were also important, as well. Many of the larger companies, in particular, have increased their emphasis on generating noninterest revenues and on controlling operating expenses. Noninterest income of the 25 largest bank holding companies, from such sources as investment banking, asset sales, service charges, and loan commitments, as well as from foreign exchange and securities trading and other activities, has more than doubled in the past five years relative to total assets. That trend may continue as the largest banking organizations search for ways to improve investor returns while minimizing their credit risks and their need for additional shareholder funds.

The relatively low level of loss provisioning continued through the first-half of 1989, as well. However, by the third-quarter, many of the largest companies had announced substantial additions to their reserves, mostly in anticipation of further losses among their foreign loans and domestic real estate credits. The latest provisions give several of the largest U.S. banking organizations reserves for developing country loans that exceed 50 percent of their exposure.

The appropriate amount for the reserve depends partly on the strategy of the lender toward this business. The indebted countries clearly need some access to new financing. Those institutions that take a long-term view and are prepared to work with the borrowers may well realize higher returns on their loans than will those who are willing to take near-term losses and withdraw from that market. There is no magic number regarding the appropriate volume of reserves for these loans. Nevertheless, our policy has been, and remains, to require additional reserves, when we believe that conditions warrant.

The third-quarter losses that some large companies have reported, while troubling, should better position the companies for the future. Moreover, some companies have coupled their announcements of special provisions with disclosure of plans to issue significant amounts of additional common stock. While efforts to resolve asset quality problems must continue, actions that increase loan loss reserves and strengthen capital are welcome.

Asset quality. Asset quality remains the principal concern facing the industry. Some earlier problems seem to have receded, such as those in the agricultural sector that ravaged many Midwestern banks, but others remain. Loans to some highly indebted countries continue to undermine the near-term earnings and competitive positions of some of the largest organizations, and the real estate markets have softened in several formerly buoyant sections of the country.

Real estate markets in New England, parts of the Southeast, and broad areas of the Southwest show the most visible signs of weakness. Problems in the Northeast have recently led several institutions there to make substantial provisions for real estate losses. Most of those expected losses, in turn, involve development and construction projects, including condominium projects, in particular. Recent trends in commercial vacancy rates, combined with other factors that could adversely affect that region's economy, could lead to problems for other banking institutions, as well.

Relative to total assets, the volume of nonperforming assets for the industry increased during the first half of 1989, after declining during 1988. The volume of weak assets remains stubbornly high for the larger banking organizations, in large part due to their expcsure to foreign borrowers. Nonperforming assets of the 25 largest bank holding companies increased slightly to 3.1 percent of their total assets at mid-year, which is well above the average 2.2 percent reported by all holding companies. I will say more about the foreign debt situation later.

Exposure to highly leveraged borrowers, including involvement in leveraged buyouts and other highly leveraged financings, also has important implications for the risk profiles of banking institutions. Such transactions can be important vehicles for the necessary restructuring of some companies and, in this way, may contribute to the operating efficiency and financial performance of U.S. businesses. Nevertheless, the higher debt levels and relatively lower equity cushions that characterize such transactions can also weaken the borrower's ability to withstand financial adversity and, other things being equal, can raise the level of risk in bank loan portfolios.

At mid-year 1989, the 50 largest bank holding companies had total loans and commitments to highly leveraged borrowers of more than $100 billion, a 20 percent increase from the level they reported at the end of 1988. Although the vast majority of these claims are in the form of senior debt, the amounts outstanding are substantial for many companies, both in absolute terms and relative to their equity capital. This is clearly an area that warrants particularly close attention by bank managers and supervisors alike.

Capital adequacy. An important indicator of the strength of the banking system is the measure of capital adequacy. Accordingly, developing both an accurate measure and an appropriate standard for evaluating the capital adequacy of banking organizations has always been of prime importance. The international risk-based capital standard adopted during the past year represents a milestone in international cooperation and should help to strengthen capital standards throughout the world.

Although the new standard is not effective until the end of 1990 and will not be fully implemented until two years later, most banking organizations are focusing on those requirements now. We estimate that about 94 percent of the nation's commercial banks met or exceeded the minimum risk-based capital standard at mid-year, even under the more-rigorous 1992 definitions. Even many of the large regional and money center bank holding companies meet the standard, or are well on their way toward meeting it.

The actions some companies have taken to raise additional capital in response to the future risk-based capital requirements also improve their capital ratios, as measured by current standards. Primary capital, for example, which includes equity capital, loan loss reserves, and a few other components, averaged 8.25 percent of adjusted assets at mid-year 1989 for all bank holding companies with assets exceeding $150 million. That figure compares with 8.08 percent at the end of 1988 and with 7.90 percent the year before. This general improvement has been widespread.

Much of the improvement in recent years has come through slower asset growth, especially on the part of the larger institutions. During 1988, total assets of all insured commercial banks grew by only 4.4 percent, compared with rates of 7 to 8 percent during the first-half of this decade and with rates in the mid- to low-teens during the 1970s. Average asset growth among the 25 largest banks has virtually stopped, increasing by only 0.6 percent last year after being virtually unchanged during 1987.

Some of that slowdown reflects efforts to meet stronger capital standards, reduce foreign exposure, securitize assets, and focus on off-balance sheet and other fee-generating activities. Growth of outstanding loan commitments and foreign exchange and interest rate contracts, for example, has been much stronger than asset growth in recent years. Transfers of certain securities activities from banks to bank holding company affiliates also explains some of the slow growth by these large banks. Measured on a consolidated holding company basis, the 25 largest institutions grew by 4.2 percent last year.

The risk-based capital standard imposes specific minimum ratios for "Tier 1" (largely equity) capital as a percent of assets. That emphasis on equity should support and, hopefully, help to extend the improvement we have seen in equity-to-asset ratios. At the end of 1988, for example, bank holding companies with assets exceeding $150 million reported equity equal to nearly 6.0 percent of their total assets--more than a percentage point higher than at the beginning of the decade. Although the the 25 largest companies reported a lower average equity ratio of 5.33 percent, their relative improvement was even greater during that period.

The thrift industry problems have demonstrated the need for financial institutions to maintain adequate levels of tangible capital to absorb unexpected losses. The Federal Reserve shall continue to enforce prudent standards for state member banks and bank holding companies and ensure that these capital standards remain sound. The role of intangible assets, such as goodwill, in the capital measure for banks is minor now and will decline further during the next few years as the new standards are put in place. We shall also continue our efforts to coordinate those standards internationally so that they are administered similarly throughout the world and that U.S. banking organizations can compete worldwide on a more equitable basis.

The Committee has asked whether the Federal Reserve believes that the U.S. banking system currently has sufficient capital to protect the public interest and avoid a serious drain of the bank insurance fund. Many bankers will testify that we seem constantly to urge higher levels of capital. Increased risks resulting from greater competition, expanding powers, and a rapidly changing environment for banking services suggest that some institutions should have materially higher levels of shareholder funds. In those cases, we have and shall continue to urge institutions to raise the necessary funds. Overall, though, the Committee should recognize the considerable progress the industry has made to improve its capital position.

In addition to issuing more equity securities, the domestic banking industry has generated substantial funds through increased retained earnings. Over the last several years, a trend toward higher earnings and lower dividend payout rates of large banks were especially helpful in that regard. During the past five years, the retained earnings of all insured U.S. commercial banks rose by $39 billion, or 79 percent. By comparison, their total assets grew by only 31 percent.

The new risk-based capital standard will identify the need for capital by relating the requirements to the specific composition of risk each organization accepts. The measure, however, is not a panacea and cannot be put on automatic pilot and then ignored. An adequate capital standard is a critical element of a sound supervisory system, but it is only one of many components. Vigilant supervision, thorough examinations, and prompt enforcement actions are other essential elements that I will address next.

EXAMINATION EFFORTS

The Federal Reserve believes that frequent on-site examinations are a critical component of an effective supervisory framework. In this regard, the Federal Reserve's policy is to examine all state member banks and bank holding companies with significant operations on an annual basis, either directly or in conjunction with state supervisory agencies. Problem institutions are examined more frequently, and are subject to other more rigorous supervisory reviews.

Conditions of the past several years, in both the banking and thrift industries, have imposed significant pressures on our field examination resources. This year, in particular, our involvement in thrift institution examinations and closings has forced us to postpone the regular periodic examinations of some institutions that appear to be healthy and to limit the examination scope of others. While we can make such adjustments temporarily, we cannot do so for extended periods. Such actions would increase the possibility that problems could develop and grow without early detection. In light of these and other developments I have discussed in this statement, it is crucial that we continue to devote adequate resources to on-site examinations and other critical supervisory functions. It is also essential that we take any steps necessary to attract and retain qualified field examiners and supervisory personnel.

INTERNATIONAL DEBT SITUATION

A significant area of concern for some of the nation's largest banking organizations continues to be their exposure to developing countries. The U.S. banking system is now much less vulnerable to debt servicing difficulties by these countries than it was in the early 1980s. That is not to say that the problem is behind us. At mid-year, exposure to problem debtor countries still represented more than 90 percent of the combined primary capital of the 9 most internationally active U.S. banks and almost 40 percent of the capital of 13 others.

Fortunately, though, this vulnerability continues to decline from much higher levels a few years ago. During 1988, alone, those 22 large banks reduced their net exposure to problem debtor countries by almost $9 billion. In the first six months of this year, they reduced it another $4.5 billion. This progress has been made by reducing the exposure through a combination of asset sales, swaps, and charge-offs and, more importantly, by strengthening the capital and reserve base of the lending institutions. Indeed, by creating strong levels of reserves, most regional and super-regional banking organizations have nearly removed these exposures as a major determinant of their financial strength.

Several large banks have recently further increased reserves against developing country debt. On balance, the Board views this as a positive development toward strengthening the banking system. However, both the banks and the regulatory agencies must continue to review these reserves on an ongoing basis to ensure that the level of bank reserves and capital is appropriate with current circumstances. Moreover, from the banks' own perspective as well as from the perspective of the international economy, commercial banks should continue to work with the borrowers and the international institutions in a continuing cooperative effort to improve the economies of these countries and, thereby, their ability to service their debts.

PROBLEM AND FAILED INSTITUTIONS

During 1988, the number of failed banks had reached another post-war high of 200 institutions, compared with 184 in 1987. An additional 21 banks with assets of $13.5 billion were operating with FDIC assistance while a permanent solution was being reached. Since the total failures included numerous subsidiaries of several of the largest Texas banking organizations, the assets of the failed banks soared to $40.3 billion in 1988 from $6.9 billion the year before.

Both the number and size of bank failures has continued at high levels this year. Through September 1989, 160 commercial banks had failed, with total assets of $25.7 billion. The failures were heavily concentrated in the Southwest. Failures in the West and Midwest declined during 1988 from their 1986-1987 peaks and accounted for only 20 failures in the first nine months of this year. With respect to the Federal Reserve's specific activities, 9 state member banks have failed through September, compared with 21 for all of 1988.

The number and assets of problem institutions also remains historically and unacceptably high, but also appear to have peaked. Both figures declined slightly in 1988 and have dropped further during 1989. At the end of the third quarter, 1,166 commercial banks were considered problem institutions by the FDIC, compared with a high of 1,575 banks at the end of 1987. Most of them are located in the Southwest, while conditions in the West and Midwest have improved. Softness in the automobile industry could aggravate economic conditions in the Midwest but, barring new major problems, should not reverse the trends toward fewer problem banks in that area.

SUPERVISORY AND REGULATORY INITIATIVES

The Federal Reserve, often in cooperation with the other federal bank regulatory agencies, has adopted a number of significant measures in recent years to address real and potential risks in banks. As indicated earlier, we have also provided significant examination resources to help identify and resolve insolvent thrifts. Several of the major new initiatives are summarized below:

Capital standards. Late last year the Board adopted a new risk-based capital standard for state member banks and bank holding companies that was based on negotiations conducted through the Bank for International Settlements. As I have suggested, this international standard emphasizes the need for "core" shareholder funds, recognizes risks in certain off-balance sheet activities, and varies the amount of capital required for various types of assets by the amount of perceived credit risk contained in each asset or exposure. This standard should tailor each institution's capital requirements more closely to its willingness to accept risk and should also lead to more equitable competition among major banks worldwide.

The Board fully supports strong capital standards and has worked hard to improve the capitalization of the banking industry. Our influence comes not only through supervisory actions, but also from administering the bank holding company application process. When deciding requests of banking organizations to merge with or acquire other institutions, the Federal Reserve has and will continue to require applicants to raise additional shareholder funds, when necessary. This process will involve prohibiting poorly capitalized institutions from expanding through mergers and acquisitions and, at times, may even require other companies to strengthen their financial positions further. In that way, the structural changes occurring within the industry can lead to a stronger banking system.

Highly leveraged financings (HLFs). Early this year the Board revised its 1984 examination guidelines on HLFs, including leveraged buyouts, to strengthen its cautionary language and to stress further the need for lending institutions to thoroughly evaluate the financial strength of the borrowers. The new statement emphasized the importance of (1) evaluating cash flows under varying economic conditions, (2) setting reasonable "in-house" limits on the consolidated exposure of HLF borrowers, and (3) establishing specific policies, procedures, and controls for HLF lending. The statement also urged banks to price these credits prudently in order to reflect adequately the trade-off between risk and return and to avoid compromising sound banking practices in a search for market share and short-term gains.

The Federal Reserve Banks have also employed these guidelines to give special attention to loans to customers with exceptionally high debt profiles. In this connection, the federal banking agencies have recently developed a definition of highly leveraged financings that they can use for examination and supervisory purposes. Such a consistent definition should help identify trends and compare the exposures of individual institutions.

New securities powers. Earlier this year, the Board agreed to permit several large U.S. bank holding companies to expand their securities activities by underwriting, on a limited basis, corporate debt and equity within the United States. However, before the companies could conduct those new activities they were required to demonstrate that they had adequate capital, managerial expertise, and controls. The Board granted its permission immediately for them to underwrite commercial debt instruments, and by mid-year four companies had done that. However, the Board has withheld for at least one year its consent for them to underwrite equities. By its conditional approval, however, the Board indicated its willingness to allow U.S. banking organizations to provide that service, if proper systems are in place to control the risks.

This decision was made in response to changing market conditions and competitive positions and on the basis of existing authority granted in the Bank Holding Company Act. The Board was mindful of any increased risks such activities might present to the organization's core banking business and took special steps to ensure that the new underwriting powers were separated from the activities of any subsidiary bank(s) and that appropriate prudential safeguards were in place to protect affiliated banks. It also took special steps to ensure that the banking organizations conducting these activities were well capitalized or that they raised additional equity to support these incremental risks. That approach should improve the ability of domestic bank holding companies to compete more effectively with foreign and nonbank institutions, while protecting the public's interest in a safe and sound banking system.

Hostile takeovers. Through past decisions, the Board has indicated its intent to remain neutral on the issue of friendly or unfriendly acquisitions of domestic banking organizations. Its principal interest in all acquisitions continues to be that the resulting organization be financially sound and have a strong capital position. The Federal Reserve will not, however, allow an institution to weaken its own condition significantly, either in an attempt to consummate an acquisition or to prevent one.

Interbank payments system. An important and on-going objective of the Federal Reserve has been the implementation of policies both to reduce Federal Reserve risk in providing payments services and to induce private participants to be more prudent in controlling their daylight credit exposures, particularly on private large-dollar payment systems. The largest of these, CHIPS, has agreed to adopt rules making settlement of their system more certain through both collateral and loss-sharing devices. In addition, the Board has adopted guidelines to reduce credit exposures on other domestic and foreign clearance and payments systems.

Last spring, the Board also proposed additional measures to encourage depository institutions to control their credit exposure by expanding the scope of its payments risk reduction program. Among other features, the proposals will impose explicit prices on Federal Reserve daylight credits and expand the use of collateral as a risk control technique for book entry clearance of U.S. government securities. When fully implemented, these changes, together with private sector initiatives, should reduce the overall level of U.S. payments system risk, shift the mix of domestic risks toward the private sector and more accurately assign the risk to the private sector users of payment services.

CONCLUSION

These past few years have been difficult times for the banking industry, and significant problems remain. However, the performance of most institutions during 1988 and for the first part of this year, suggests that progress has been made. The number of failed institutions seems poised to decline; the capital ratios for most banking organizations have strengthened; and the most severe problem institutions have now been addressed. We must see further gains, though, before we can say that the problems that have beleaguered the industry are behind us.

The CHAIRMAN. Mr. Clarke.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. CLARKE. Mr. Chairman and members of the committee, I, too, am pleased to respond to your invitation to present our views on the condition of the banking industry and on a number of other issues related thereto.

One of the hazards, of course, of speaking third on a subject is that by the time you have the opportunity to speak, a lot has already been said on that subject. And, since I have submitted for the record a fairly lengthy written statement which contains a lot of good information in response to your questions, I want to focus my time this morning on one subject that I think is very important, one that you mentioned in your opening statements: bank capital, and particularly the risk-based capital guidelines or what we call the tandem leverage ratio.

I think it is important for you to have a clear picture of what we are doing and why we are doing it as federal bank supervisors move to a tougher and more appropriate measure of capital adequacy. Unfortunately, there has been a lot of misunderstanding and a lot of misinformation on this subject.

Last winter, after years of negotiation internationally and domestically, all three Federal bank regulators, along with the banking authorities in 11 other nations, adopted risk-based capital rules for commercial banks. These rules were based on the principle that a bank's capital requirement should reflect the riskiness of its assets. They were also based on the principle that all banks should be required to hold core capital—equity capital.

But, asset risk is not the only risk that banks face. They must also deal with interest rate risk and operating risk, just to name two others. And, their principal protection against these risks is capital.

So all three federal bank regulators agreed that, in addition to the risk-based capital guidelines, there had to be some minimal level of capital that a bank has to hold. At the OCC, we call that minimum capital level the "tandem leverage ratio." It is a "backstop," a supplement. It is a backstop because, without it, the guidelines, theoretically, could allow a bank to operate with no capital, for example, by investing all of its deposits in U.S. Government securities, which have a zero risk-weighting. And, the tandem leverage ratio is a supplement because a bank would have to meet—at a minimum—both the risk-based guidelines and the tandem leverage ratio.

A bank that satisfies one minimum requirement, but not the other, would have to raise capital or adjust its portfolio so that it meets all capital requirements. Therefore, the tandem leverage ratio cannot be viewed in isolation. Its purpose and its effectiveness must be evaluated in the context of the overall system of capital regulation.

In that regard, the risk-based capital standards themselves will begin to be phased in at the end of 1990, and they will be in effect fully two years later. When they are in effect, national banks will be expected to hold 8 percent capital-to-assets after all of the weighting for risks are taken into consideration. Eight percent is a minimum, just as the capital guidelines that we are phasing out are minimums. Most banks will be expected to maintain even higher capital levels. And, historically, most banks have operated at capital ratios far higher than the minimums that we have set in the past.

Even so, the new capital standards will require significantly more banks to raise capital than the current rules do, and they will require significantly more capital in the banking system. About 50 percent more banks would fail to meet the risk-based guidelines today than fail to meet the current requirements. The total amount of capital required for all banks to meet the risk-based rules would be about $209 billion, compared to the approximately $185 billion required to meet current capital standards. That's right, $24 billion more!

Furthermore, under the risk-based approach, banks that pose the greatest potential threat to the FDIC insurance fund will be the ones that must raise additional capital.

Ten percent of the banks in this Nation would be required to have more capital under the risk-based capital standards than under current standards. And, those banks hold 70 percent of the assets in the banking system.

Last March, I suggested a leverage ratio equal to 3 percent of total assets, a ratio to be made up totally of "hard" capital—capital like stockholder equity—capital in its most tangible form. It is important to remember that this minimum would work in tandem with the risk-based guidelines. Why 3 percent? Quite simply because it strikes a balance. It allows the risk-based capital standard to work while at the same time it would protect the safety and soundness of the national banking system. Higher or lower minimums would result in one or the other of these goals being compromised. So we formally proposed that 3 percent be set as the tandem leverage ratio.

For various reasons, there is a great deal of misunderstanding about what we have proposed and why we have proposed it. Let me set the record straight. Our proposal would not result in the wholesale lowering of capital standards for national banks. Our proposal, in conjunction with the 8 percent risk-based minimum, would raise the amount of capital in the system over the present standard.

The 3 percent leverage ratio will not become the operative capital level for national banks. Instead, because the asset mix at most national banks is as it is, the 8 percent risk-based minimum establishes the floor from which we will build upward to establish acceptable capital levels at each institution.

As I noted, a higher tandem leverage ratio would undermine the risk-based features of our new guidelines. In doing so, it would undermine all of the work that all three U.S. banking agencies have devoted to matching a bank's capital requirements to the riskiness of its business, as well as the work of all of the industrialized nations that have agreed to the risk-based capital structure.

I believe that you either have a risk-based capital standard, or you don't. Either you support the concept that capital requirement should be tied to the riskiness of a bank's activities, or you support the current approach. There is no middle ground.

A higher tandem leverage ratio, which may appear reasonable on its face, will destroy the thrust of the risk-based system.

Mr. Chairman, we have been through the debate on whether risk-based capital is preferable to what we have now. The question was settle. It is preferable. That being the case, we should proceed to implement it.

I have attached an addendum to my written statement that explains our tandem leverage ration in more detail.

Thank you very much.

[The complete prepared statement of Robert L. Clarke follows:]

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
October 25, 1989

INTRODUCTION

Mr. Chairman and members of the Committee, I am pleased to respond to your invitation to present the views of the Office of the Comptroller of the Currency (OCC) on the condition of the banking industry and a number of other issues related to the supervision of commercial banks. Because I come to this discussion as the primary supervisor of national banks, my comments will deal principally with the condition and supervision of those banks.

My testimony is divided into three parts. I will begin with an explanation of why I believe that the current financial condition of the national banking industry is fundamentally sound. Second, I will review some of the important developments that adversely affected national bank performance earlier in the 1980s, or have the potential to depress performance in the future, and the steps we have taken to address them. I will conclude my testimony by describing the basic aspects of our supervisory approach that are designed to strengthen the national banking system.

THE FINANCIAL CONDITION OF THE NATIONAL BANKING SYSTEM

Overall, the national banking system is sound, and in many ways its condition has improved since I last reported to this Committee in May of 1988. During 1988 and the first six months of 1989, most national banks improved their capital positions and their profitability. Trends in bank capital were particularly encouraging during those 18 months; national banks added $13.9 billion to their equity capital. Increases in bank earnings were also noteworthy during 1988 and the first half of 1989, but were less encouraging than the improvement in bank capital positions; the magnitude of the year-to-year increases in aggregate reported profits gave an exaggerated impression of the strength of national bank earnings.

Although we are encouraged by the improved capital levels at national banks and the recent rebound in their profitability, prospects for sustaining that momentum are less encouraging for the second half of this year. Large multinational banks continue to face uncertainties surrounding their loans to developing countries; numerous banks in the southwest remain burdened by nonperforming real estate loans and a slowly recovering economy; and banks in other parts of the country have recently experienced a deterioration in the quality of their real estate portfolios. As a result of those problems, we anticipate additional provisions against developing country debt by some large national banks; continuing national bank failures, concentrated among smaller institutions in the southwest; and rising real estate loan losses in some markets. While none of those developments threaten the safety and soundness of the national banking system, they do pose problems for individual banks and will likely necessitate increased allocations to loss reserves and a continuing need to increase equity capital.

Earnings

From the beginning of 1988 through June 30 of this year, the aggregate net income of national banks increased substantially. In 1988, national banks reported earnings of $13.7 billion, about $14.0 billion above their depressed levels in 1987. Earnings were also up in the first six months of this year, $3.7 billion above levels reported in the first six months of 1988.

Much of the rise in national bank income in 1988 and the first six months of 1989 was due to unique circumstances, however. Two were especially significant. First, the failure of over 100 unprofitable national banks during those 18 months introduced significant distortions in year-to-year comparisons of aggregate earnings. Second, sizable year-to-year variations in loan loss provisions, especially among very large national banks, contributed to large swings in reported income from one year to the next.

Most of the growth in reported net income during the first six months of 1989, compared to year-earlier totals, was attributable to the distortions introduced by the failure of 102 national banks between June 30, 1988 and June 30, 1989. They dragged down aggregate earnings in 1988, but they were not around to do that in 1989. Those banks reported losses of more than $2.5 billion in the first half of 1988, but, because they failed, they were not among the banks reporting for the first half of 1989. Among national banks that did report in both periods, half-year earnings increased by about $1.2 billion, which was approximately one-third of the overall rise in aggregate reported national bank income. Thus, the magnitude of the overall rise in reported profits in the first half of 1989 could give an exaggerated impression of the strength of national bank earnings.

The magnitude of the rise in the aggregate earnings of national banks between 1987 and 1988 was also misleading, but for a different reason. Most of the rise in the aggregate earnings of national banks between 1987 and 1988 was due to changes in loan loss provisions at the 31 largest national banks -- those with assets above $10 billion. In 1987, many of those banks made special loan loss provisions against their loans to less developed countries (LDCs), which significantly depressed their reported net income that year. By contrast, the absence of further significant allocations to LDC debt reserves by those banks in 1988 boosted their reported profits.

Not surprisingly, then, the rise in the aggregate earnings of national banks between 1987 and 1988 was concentrated in those 31 large banks. Their loan loss provisions dropped by $12.3 billion in 1988 compared to 1987, and their reported profits rose by $12.2 billion. That accounted for 87 percent of the total rise in the net income of national banks last year. (See Table 1.)

TABLE 1

NET INCOME
(All National Banks)

Year	Less than $300mm	$300mm to $1bn	$1bn to $10 bn	Greater than GT $10bn	Total
1978	$1,851.1	$ 715.7	$1,661.0	$ 1,929.3	$6,157.2
1979	2,079.6	777.7	2,050.7	2,333.0	7,241.0
1980	2,190.3	859.2	2,082.9	2,527.4	7,659.8
1981	2,224.7	895.1	2,230.2	2,831.8	8,181.8
1982	2,208.5	805.0	2,339.4	2,841.0	8,194.0
1983	2,170.6	893.8	2,533.2	2,433.2	8,030.8
1984	2,020.9	1,090.8	3,811.7	1,383.1	8,306.5
1985	1,793.5	929.7	4,462.6	2,672.0	9,857.8
1986	1,296.3	844.4	3,652.6	3,724.7	9,518.8
1987	1,414.1	754.5	2,312.7	-4,759.6	- 278.3
1988	1,477.7	815.0	4,024.5	7,391.0	13,708.2

Source: Call Reports

In the future, as circumstances change or new information becomes available, banks with LDC loans outstanding may find it prudent to make further allocations to their reserves for LDC debt. Already, for the third quarter of this year, some large multinational banks -- including nationally chartered banks -- have announced additional allocations to their reserves. Those provisions will substantially reduce the reported net income of those banks in the second half of this year and may cause them to augment their equity capital in the future.

Return on Assets

With earnings of $13.7 billion on average assets of $1.8 trillion, the mean return on assets (ROA) was 0.76 percent for national banks in 1988. That represented a dramatic increase from the -0.02 percent registered in 1987 and was the highest level since 1979. (See Table 2.)

TABLE 2

RETURN ON AVERAGE ASSETS
(All National Banks)

Year	Median	Mean
1978	1.01%	0.73%
1979	1.09	0.77
1980	1.11	0.73
1981	1.08	0.71
1982	1.04	0.66
1983	0.97	0.60
1984	0.92	0.58
1985	0.88	0.63
1986	0.77	0.57
1987	0.78	- 0.02
1988	0.90	0.76

Source: Call Reports

As with the aggregate earnings data, however, the mean ROA was greatly influenced by the results reported by the 31 largest national banks, which last year accounted for 54 percent of national bank income and 45 percent of national bank assets. In order to capture trends reflecting the profitability of the vast majority of national banks, which are smaller institutions, the OCC monitors changes in the median ROA. The median is the middle value; the ROA of half of all national banks exceeds the median; and the ROA of the other half of all national banks is less than the median.

Median ROA increased in 1988 for the second consecutive year, following six years of significant decline. Median national bank ROA was 0.90 percent in 1988, its highest level since 1984 and 0.12 higher than its level in 1987. (See Table 2.) In the first half of this year, median ROA increased further, to 1.04 percent, 0.13 higher than its level a year earlier.

Recent increases in ROA, however, have not fully offset earlier declines in profitability -- a fall of 0.32 in median ROA and a drop of 0.20 in mean ROA between 1979 and 1986. Nowhere have earnings weaknesses been more resistent to improvement than among the poorest performing banks, those with an ROA below the median. Between 1979 and 1986, the ROA of banks in the lowest fifth percentile of national bank ROA dropped 3.72, and despite a recent improvement in profitability -- the fifth percentile ROA increased 0.49 basis points between 1986 and 1988 -- those banks still lost money at the rate of 2.95 percent of assets in 1988. (See Table 3.)

TABLE 3

DISTRIBUTION OF RETURN ON ASSETS
(All National Banks)

Year	5th Percentile	Median	95th Percentile
1978	0.18%	1.01%	1.70%
1979	0.28	1.09	1.87
1980	0.11	1.11	2.02
1981	-0.05	1.08	2.20
1982	-0.91	1.04	2.10
1983	-1.31	0.97	1.96
1984	-2.08	0.92	1.84
1985	-2.91	0.88	1.84
1986	-3.44	0.77	1.75
1987	-3.05	0.78	1.67
1988	-2.95	0.90	1.72

Source: Call Reports

Return on Equity

Another measure of profitability, usually used in conjunction with ROA, is return on equity (ROE). ROE equals the ratio of net income to average shareholders' equity for the period in which that income was earned.

Recent trends in bank ROE have been broadly consistent with those for ROA. Median and mean ROE both declined between 1979 and 1986, by 4.31 and 4.69 respectively. As was the case with ROA, however, both the median and the mean ROE rose substantially in 1988. Median ROE rose to 10.88 percent, its highest level since 1985, and mean ROE rose to 13.24 percent, its highest level since 1980. (See Table 4).

TABLE 4

RETURN ON AVERAGE EQUITY
(All National Banks)

Year	Mean	Median
1978	13.12%	13.36%
1979	14.04	14.22
1980	13.37	13.93
1981	13.03	13.47
1982	11.93	13.02
1983	10.63	12.18
1984	9.96	11.58
1985	10.72	11.13
1986	9.73	9.53
1987	-0.28	9.54
1988	13.24	10.88

Source: Call Reports

In the first six months of 1989, mean and median ROE increased further, compared to year-earlier levels. Median ROE rose 154 basis points and mean ROE increased by 598 basis points. Those increases occurred, moreover, despite substantial increases in the equity capital at national banks during that period.

Capital

National bank capital ratios have generally increased since 1979, and that trend continued in 1988 and the first half of 1989. Since 1987, the trend to higher primary capital, and especially equity capital, has been particularly pronounced among the national banks in the largest size category, those with assets above $10 billion. (See Table 5.)

TABLE 5

AGGREGATE EQUITY CAPITAL AS A PERCENT OF TOTAL ASSETS
(All National Banks)

Year	Less to $300mm	$300 to $1Bn	$1Bn to $10Bn	Greater than $10Bn	Total
1978	7.55%	6.44%	5.56%	4.13%	5.51%
1979	7.72	6.54	5.53	4.02	5.45
1980	7.90	6.75	5.50	4.05	5.47
1981	7.97	6.73	5.58	4.13	5.47
1982	7.97	6.73	5.54	4.22	5.52
1983	7.90	6.73	5.71	4.42	5.66
1984	7.92	6.74	5.67	4.94	5.87
1985	7.86	6.70	5.83	4.97	5.90
1986	7.63	6.55	5.72	5.21	5.87
1987	7.87	6.60	5.89	4.54	5.64
1988	7.87	6.45	5.92	5.09	5.86

Source: Call Reports

We anticipate that national banks will continue to augment their capital, especially their equity capital, as the result of risk-based capital guidelines scheduled to take effect at the end of next year. Those guidelines will base minimum capital standards on the riskiness of bank assets. They will also provide, for the first time, regulatory guidance on the minimum amount of equity capital banks should maintain. This is especially important, since it is equity that that provides an unambiguous cushion against unforeseen losses. When the guidelines take effect, banks with assets judged to be relatively risky, or with risky off-balance-sheet exposures, will have to hold more capital, including a higher portion of equity capital, than they are required to hold at present.

Credit Quality

In 1988 and the first half of 1989, the overall credit quality at national banks improved as the rate of loan losses dropped (see Table 6), nonperforming assets as a percentage of all assets fell, and allocations to reserves for future loan losses declined, compared to year-earlier figures. Those improvements followed a steady deterioration in credit quality earlier in this decade, a deterioration that occurred despite a protracted period of economic growth.

TABLE 6

NET LOAN LOSSES AS A PERCENT OF AVERAGE LOANS
(All National Banks)

Year	Median	Mean
1978	0.16%	0.34%
1979	0.18	0.29
1980	0.24	0.37
1981	0.26	0.35
1982	0.35	0.59
1983	0.35	0.71
1984	0.37	0.86
1985	0.56	0.88
1986	0.73	1.01
1987	0.56	0.98
1988	0.41	1.07

Source: Call Reports

Some of the deterioration in credit quality earlier in the 1980s stemmed from economic weaknesses that were concentrated in certain regions of the country or sectors of the economy. Earlier in this decade, banks serving agricultural communities suffered substantial losses following a drop in the prices of many agricultural commodities, which, in combination with falling exports and a heavy debt burden, cut farm income. Banks with loans to the oil and gas industry experienced similar problems following the decline in worldwide oil prices and the contraction of the domestic energy industry. Beginning in 1987, however, conditions in both the agricultural and energy sectors began to stabilize, and credit quality at national banks serving those sectors improved.

Since the middle of the decade, nonperforming real estate loans have become, and remain, a significant supervisory concern. Nonperforming real estate loans at national banks more than doubled between 1984 and 1988 -- from $8.2 billion to $17.4 billion, and increased to $20.8 billion as of June 30 of this year. Through 1987, the growth in nonperforming real estate loans occurred primarily in the southwest, but in the 18 months ended June 30, increases occurred in other parts of the country, and were largely concentrated in the northeast.

Future Prospects

Looking to the future, prospects are mixed. Continued economic health will produce some rise in earnings, profitability, and capital levels in the majority of national banks during the next year. Those improvements, however, will probably be at rates below those witnessed over the last 18 months.

Of course, some national banks will not share in those improvements. In the southwest, there will continue to be a higher number of bank failures than we would like to see, though those failures will generally involve smaller banks than in the past 18 months. The vast majority of those failures will involve banks that are already burdened by a high level of nonperforming loans that were booked in the past. Although we will succeed in working with some of those banks to save themselves -- through an infusion of capital, improved banking practices, changes in management, merger or consolidation, or other corrective actions -- experience suggests that a number of those 4-rated banks and most of the 5-rated banks will fail and either be closed or acquired by healthier institutions.

Elsewhere, some national banks will experience difficulties due to their individual circumstances. Many of the largest banks will continue to wrestle with the problem of deciding what is the most appropriate provision for their LDC debt and their most prudent stance in financing highly leveraged transactions (HLTs). Other banks could be affected by current and forecasted weaknesses in real estate markets that could contribute to a deterioration in the performance of their real estate loans.

Over the longer term, changes in the nature of bank competition, as well as underlying economic conditions, will affect the performance of commercial banks. Those changes in bank competition include product and geographic restraints on banks that have kept banks from responding fully to innovation by their chief competitors. At home, banks have witnessed borrowers accessing capital markets directly and depositors placing funds with firms that provide investment banking, insurance, and other financial services -- firms that do not face the same geographic restrictions as do banks.

Overseas, we have witnessed the ascendency of foreign banks, and the financial integration of the European Economic Community will likely increase their competitive advantage. For example, foreign banks will be able to market European securities in their home countries, where their principal pool of customers is located. In sharp contrast, U.S. banks will be prohibited by the Glass-Steagall Act from marketing European securities in their home country, where their principal pool of investors is located. U.S. banks will be unable to develop the marketing and operational efficiencies that they will need to become effective players in European and domestic markets.

There is more at issue than the international standing and competitiveness of U.S. banks, important as that is. Most importantly, consumers would benefit from reducing the geographic and product market barriers that now constrain banks. Consumers would benefit individually, for increased competition holds the key to better product prices, quality, and innovation. They would benefit collectively because expanded opportunities hold the key to a more efficient and stronger financial system.

The stakes are high, and reticence to push forward is costly. Some might wish to proceed slowly because of the thrift crisis, but the differences between the banking and thrift industries are far more significant than the similarities. One of the most striking differences is that of supervision. As I have testified on numerous occasions before many Congressional committees, there is a large number of steps we have taken and can take to ensure that a more competitive banking system will continue to be a safe and sound banking system. Some of those steps involve our supervisory process, which I will describe shortly.

Mr. Chairman, that concludes the first portion of my assessment of the condition of the banking system. I turn now to specific areas of concern that did, and may continue to, spell trouble for important groups of banks. These areas are the economy of the southwest, real estate markets, loans to less-developed countries (LDCs), and highly leveraged transactions (HLTs).

SPECIFIC AREAS OF CONCERN

Southwestern Economy

Lingering asset quality problems and a slow recovery of the economy have contributed to relatively high numbers of bank failures in the southwest in recent years. In 1988, 147 of the 198 FDIC-insured commercial bank failures occurred in just three states in the southwest -- Texas, Oklahoma, and Louisiana. In the first nine months of 1989, 132 of the 156 FDIC-insured commercial bank failures were located in those states.

To some extent, however, those data may give an exaggerated impression of the number of banking organizations affected by failure. In 1988, for example, 41 of the failed banks were affiliated with just one bank holding company headquartered in Texas. In the first nine months of 1989, 44 of the failed banks were part of just two multibank holding company chains headquartered in that state. Nevertheless, the pace of bank failures was and remains a serious issue in the southwest. We expect continuing high numbers of bank failures there in the rest of this year and in 1990. Future failures, however, should involve smaller banks and fewer banks affiliated with holding company chains.

For commercial banks operating in the southwest, current problems stem from lending decisions made several years ago. As the outlook for the oil and gas industry began to dim in 1982-83, undermining the quality of oil and gas loans, many banks shifted their lending emphasis. Booming demand for construction finance in Texas led local lenders, including commercial banks, to expand their commercial, and to a lesser extent their residential, real estate loan portfolios.

In retrospect, it is clear that the level of construction, especially in Texas, was excessive. Ultimately, after the collapse of oil prices in 1986, construction activity in Texas contracted sharply, but by then it was too late to forestall the damage to many of the financial institutions that had been the most aggressive real estate lenders.

Many national banks in the southwest are still beset by problems in their real estate loan portfolios. In the Southwestern District (which includes the states of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas), nonperforming real estate loans at national banks amounted to $6.9 billion at the end of June, representing about 75 percent of the total nonperforming assets of those banks. Although this level of nonperforming real estate loans was about $2.9 billion less than a year earlier, the decrease was due principally to the transfer of problem assets to the FDIC as banks failed, rather than an improvement in the performance of individual loans.

Problems related to real estate, however, are not restricted to the southwest, and it is to those problems that I now turn.

Real Estate

As the rate of growth in their traditional commercial and industrial (C&I) lending slowed, real estate lending by national banks (and all commercial banks) accelerated during the 1980s. By the end of 1988, in fact, real estate loans held by national banks exceeded their outstanding C&I loans by $96.4 billion.

At the end of last year, real estate loans at national banks totalled $407.5 billion, and, on average, they accounted for 35 percent of total loans. The median ratio of real estate loans to total loans was 44 percent. By way of contrast, the corresponding ratios for 1982 were 25 and 32 percent, respectively.

In 1988, national banks in five of the six OCC districts -- the exception was the Southwestern District -- continued to increase their exposure to real estate. In the Southwestern District, real estate lending declined by 13 percent, but in the other five districts, year-to-year growth ranged from 11 percent in the Western District to 18 percent in the Southeastern District. The growth in real estate lending pushed average ratios of real estate loans to total loans to new highs. At the end of 1988, for example, the ratio for the Southeastern District was 44 percent, the highest of all districts.

Those highs were reached at a time of spreading weakness in real estate markets, particularly markets for commercial properties. Many experienced observers have identified major metropolitan areas up and down the east coast, in the southwest, and in the west with above average vacancy rates in commercial real estate markets. Some of those experts forecast continuing hard times for commercial real estate developers and for homebuilding, which nationwide has been in something of a slump since the beginning of the year. For example, housing starts for the first nine months of this year were six percent below the rate for the same period in 1988.

We also see other indicators of weakening real estate markets. The ratio of nonperforming real estate loans to total nonperforming loans of national banks, for example, has grown throughout the country. Nationwide, over the last two years, the average of that ratio increased from 36 percent to over 40 percent, and at the end of last year, ranged from a low of 21 percent in our Northeastern District to a high of 74 percent in the Southwestern District.

We have responded to the growth in real estate loans by national banks, and the rise in the percentage of those loans that are nonperforming, in several ways. In 1987, the federal banking agencies issued guidelines to all insured commercial banks with respect to obtaining reliable real estate appraisals. Those guidelines contained standards by which bankers could judge the appropriateness and completeness of real estate appraisals they received. Also in 1987, the OCC gave increased emphasis to its monitoring of conditions in real estate markets and the real estate exposure of national banks.

Initially we focused on real estate markets in Texas and the factors contributing to the problems being experienced by Texas banks with relatively high exposures to commercial real estate. Then, in April and May of 1988, specialized reviews that focused on real estate lending risks were conducted at several regional banking companies in our Southeastern District. Corrective actions were required of those banks found to have inadequate loan loss reserves or weak policies and procedures governing their real estate practices. Later that year, we issued an OCC Advisory to all national banks highlighting our concerns about increased real estate exposure and about examination findings that some banks had failed to follow sound principles in making such loans and monitoring their performance. In particular, we cited our concerns about the absence of formal procedures governing reappraisals of real estate values.

Toward the end of 1988 and in the early months of 1989, we conducted special examinations of national banks in the northeast with large real estate loan exposure. Although real estate lending is not, in itself, unduly risky, prudence dictates that loan portfolios be diversified. It also dictates that before real estate loans are made, local markets should be analyzed, prospective projects should be evaluated for their economic substance, and margins for error should be built into lending contracts. For banks with high real estate exposure and relatively weak means to control and manage that exposure, the OCC required bank management to adopt corrective measures.

Our monitoring of market trends and bank exposure continues as do our examinations targeted on real estate lending practices. We have also been working with the other federal bank regulators to implement the many provisions of FIRREA, including those dealing with real estate appraisals. The results of those efforts will provide bankers and their supervisors with improved assurances that the real estate values relied upon by banks are realistic.

Less Developed Countries

A third area of concern to the OCC continues to be the status of loans to less developed countries (LDCs), although our concern today is less than it was a few years ago.

As of March 31, 1989, 165 U.S. banks reported holding $257 billion in cross-border, non-local currency claims on foreign borrowers. Of that amount, $74 billion was due from troubled developing country debtors. This figure represents a $28 billion reduction in the aggregate exposure of the U.S. banking system to such debtors since year-end 1982, when total exposure stood at $102 billion.

Over the same period, the aggregate primary capital of the U.S. banks with loans to troubled developing countries has more than doubled, from $58 billion to $133 billion. Expressed differently, these banks lowered their LDC exposure to 56 percent of aggregate primary capital as of March 31, 1989, down from 176 percent at the end of 1982.

Those are welcome developments, but they do not tell the whole story. It was just about two years ago when U.S. banks set aside record provisions for possible losses on their loans to developing countries, and we cannot rule out the possibility of additional large-scale provisions on remaining LDC debt in the future. As I stated earlier in my testimony, several banks have already set aside provisions for that purpose in the third quarter, and more are possible by year-end.

Reviewing how banks manage their developing country lending exposure is an important facet of our supervision of heavily exposed institutions. That review includes an evaluation of the adequacy of general loan loss reserves and the bank's overall capital position. Based on our reviews, we have encouraged banks with significant exposures to strengthen their loan loss reserves and capital.

Monitoring provisions for loan losses is, however, only one part of our total effort. Since the early 1980s the OCC has strengthened the supervision of international lending operations of U.S. banks. The continuation of actions taken by bank regulators, and measures taken voluntarily by banks, have resulted in reductions in bank exposure to developing country debt. Nonetheless, the remaining levels of exposure at larger U.S. banks require careful management and regulatory oversight.

Our supervisory efforts have also included a series of regulatory interpretative letters over the past two years. In those letters, the OCC has facilitated attempts by banks to reduce their LDC debt burdens, by allowing LDC-based debt-equity swaps and debt securitization transactions. Those actions are consistent with additional options for dealing with LDC debt suggested by Secretary of the Treasury Nicholas Brady at the Bretton Woods Conference in March.

Highly Leveraged Transactions

Another area of concern for both bankers and bank supervisors is highly leveraged transactions (HLTs). Popularly known as LBOs -- for leveraged buyouts -- many firms were purchased and "taken private", or recapitalized, with substantial amounts of borrowed funds and little, if any, of the buyers' own money.

Since HLTs by their nature involve higher levels of debt than are present in conventional transactions, there is a greater question of whether the purchased firms can generate, through earnings and the sale of assets, sufficient funds to repay creditors in accordance with the underlying debt instruments. Banks participate in HLTs mostly by making loans, although a limited few take equity participations through affiliates, such as Small Business Investment Corporations, that may be subsidiaries of a parent holding company. Consequently, we want to make sure that their participation in HLTs does not threaten their safety and soundness.

Certain protections are already in place. HLTs, like all loans, are subject to the lending-limit provision of 12 USC 84, which restricts loans to a single borrower to 15 percent of the capital and surplus of the bank; loans secured by readily marketable collateral are permitted up to an additional 10 percent. Moreover, OCC Banking Circular 181, issued in August 1984, describes controls that we believe are appropriate for any bank that buys loans or loan participations. Its importance in the case of HLTs is underscored by the fact that those who originate them count on selling participations, mostly to regional banks, but in some cases community banks as well.

Against that background, we undertook in the spring of 1988 a study of HLTs at 16 of our largest institutions. We found that banks generally took senior debt positions in HLT financings, which were generally secured. Much of the subordinated debt that makes up large portions of such financings is in the form of bonds and is not held by banks.

We followed up our fact-finding with a supervisory approach in which we:

- issued Examining Circular 245 on December 15, 1988, which gives detailed guidelines on how examiners will review bank policies and procedures for financing HLTs;
- issued a handbook in April 1989, which describes practices banks have found to be effective in managing their HLT activities;
- estimated the volume of of HLTs in national banks; and
- determined the quality of HLTs in national banks.

To obtain information on the volume of HLTs, we turned to our database of Shared National Credits (SNC). A SNC is any loan of $20 million or more that is shared by two or more depository institutions; HLT data are not available from the usual reports filed by banks. As of the 1989 SNC examinations, we found, among all shared national credits, $174 billion in HLT loans originated by U.S. banks, of which $101 billion had been funded. Since the SNC database probably captures about 75 percent of all HLT originations, we estimate that total HLT originations at that time were approximately $230 billion.

During the first half of this year, we also investigated two sources for information on HLT credit quality at large national banks -- special examinations and the SNC database. Together, they told us that many of the banks had adopted policies and procedures similar to those described in the Examining Circular. Generally, asset quality was good, with HLT portfolios performing at least as well as, and, in many instances better than, overall loan portfolios.

However, more recent evidence suggests that the credit quality of some HLT loans has begun to slip. First, by mid year, the ratio of criticized HLTs to HLTs outstanding had risen to 17 percent from the 9 percent level of last December. Part of that increase was due to a change in the definition of an HLT employed by banks, part was due to a shift in assessment standards, and part was due to an decrease in the quality of those loans. Second, some banks reported difficulty in selling the full volume of participations that they originally scheduled. This difficulty was due, in part, to a rise in the number of participations available, but it also stemmed from an apparent decline in the quality of some of those HLTs. Further deterioration in credit quality is likely, because most HLT credits are young -- about 18 months on average -- and experience has shown that a portfolio of loans deteriorates with age.

As we proceed with our monitoring of HLT financing, we must keep in mind that it is a legitimate product for banks. It is a new product for them, however, and as in the case of all new products, problems are to be expected, and special care must be taken until all aspects of the product and its market are fully understood. The actions we have taken are designed to assure that we and bankers develop that understanding.

Mr. Chairman, that concludes my list of major problems facing banks and bank supervisors today. I turn now to describing the basic features of our approach to bank supervision, which is designed to strengthen the national banking system.

THE SUPERVISORY PROCESS

Our primary function is to ensure that the banking system operates soundly and that banks comply with the law. To that end, the OCC assesses the condition of national banks to evaluate their management process, to see that bank management takes steps (including adding to capital) to correct weaknesses, and when private capital supporting a national bank is depleted, to close the bank in a timely manner. That process serves several public policy goals, such as ensuring a stable banking system fully deserving of complete public confidence and minimizing calls upon the Bank Insurance Fund.

We take our supervisory responsibilities very seriously and are committed to providing supervisory processes that will ensure the continued safety and soundness of the banking system and avoid a future crisis at the Bank Insurance Fund. To that end, our supervisory process involves three essential elements: our capital regulation, including our risk-based capital guidelines; our ongoing supervision of banks to keep us apprised in a timely way of their performance, policies, and procedures; and our approach to initiating enforcement actions, when weaknesses at individual banks are uncovered.

Risk-Based Capital

The new capital guidelines are to be fully implemented in 1992, and at that time each national bank will be required to maintain total capital equal to at least 8 percent of risk-weighted assets. At least half of that total capital will have to consist of core capital, principally common equity and some types of preferred stock; the remaining half may be supplementary capital, which includes other types of preferred stock, subordinated debt, and hybrid capital instruments. Both ratios are minimums; most banks currently operate, and will be expected to continue to operate, with capital levels well above supervisory minimums.

We believe that capital requirements should be linked directly to all of the risks a bank faces, and prudence requires that some minimum level of capital -- preferably core capital -- be maintained, even if the credit risk of a bank's asset portfolio is very low. Therefore, we are also proposing to require banks to maintain a minimum core capital to total asset ratio -- referred to as the tandem leverage ratio -- of at least 3 percent. In so doing, we will be requiring national banks to hold no less than a minimum amount of pure equity capital that will be available to absorb losses from unanticipated or extraordinary events.

The leverage ratio, which is explained in detail in an addendum to this testimony, will operate in tandem with minimum risk-based capital requirements (banks will be required to meet both tests). Implementation of the new requirements will affect many banks, especially the largest ones. We estimate that almost 700 banks with over 40 percent of all bank assets would not meet risk-based capital standards if they were fully in effect today. If these bank make no changes in their portfolios, they would have to add $23 billion to their capital base.

In their totality, the risk-based guidelines and the tandem leverage ratio, are designed to affect banks in three important ways. First, the risk-based capital requirements will create a better alignment between capital and credit risks. Second, by requiring capital for off-balance-sheet activities, the new requirements will lead banks to review carefully how they market and price those services. Third, redefining capital to require a minimum amount of equity will increase the ability of banks to absorb losses from unanticipated events.

We are confident that we have improved our approach to the assessment of capital adequacy. We are also confident that much additional work lies ahead. Thus far we have incorporated mainly credit risk in our guidelines. There are many more risks that need to be taken into account more explicitly, and we are working toward that end. For example, we have distributed guidelines to be used by examiners when evaluating interest rate risk, one of the more complex risks faced by all banks. We will make similar educational efforts in the future, as we develop more extensive guidelines for examiners (and bankers) for the management of other risks, such as operational risks and exchange-rate risks.

Our capital policy needs to be strengthened in other areas as well. This is particularly true of the area of bank closure. At present, we close a bank at the time its primary capital is exhausted. We have proposed that banks be closed when their equity is exhausted, which usually occurs well before primary capital reaches zero. Adoption of that proposal will permit us to close banks sooner, when shareholders no longer have an investment left in the bank, and we hope it will reduce FDIC outlays currently associated with bank closings.

Ongoing Bank Supervision

Under our supervisory process, every national bank is supervised by the OCC on an ongoing basis. Each institution is assigned an examiner who is responsible for regularly gathering and analyzing extensive information on the banks for which the examiner has responsibility. This approach places the primary responsibility with the person who has the most direct knowledge of the condition of individual banks -- the field examiner.

The field examiner is charged with gathering information and performing analyses designed to assess and address the level of risk in each bank. The sources of information include regularly filed financial reports, special requests made of the bank, reports generated by bank management information systems, and visits to the bank. Analyses are performed at the bank and at other locations, with a variety of sophisticated analytic tools. The results of those analyses are provided to OCC management and to the management and board of directors of the bank.

Because we rely to some extent of data provided by banks, I think it is important to understand why that reliance is warranted. In general, I am confident that the accounting rules banks must follow for reporting earnings promote a reasonably accurate picture of bank performance.

The rules for banks and bank holding companies come from two complementary sources -- the public accounting profession and the federal bank regulatory agencies. Members of the accounting profession examine both bank and bank holding company financial statements. At a minimum, they seek to assure themselves and the public that the values in the various asset, liability, income, and expense accounts comply with generally accepted accounting principles (GAAP). Bank regulatory agencies play a role because they require each insured commercial bank to file a quarterly Report of Condition and Income -- also known as the Call Report. Those financial statements must be prepared according to specific instructions issued by the Federal Financial Institutions Examination Council (FFIEC), of which all three federal bank supervisory agencies are members.

The federal bank supervisory agencies seek the greatest possible harmony between GAAP and Call Report requirements. At the OCC, the Bank Accounting Division reviews the Statements of Financial Accounting Standards and other bulletins issued by the Financial Accounting Standards Board (FASB) -- a self-regulatory body for the accounting profession -- for their application to national banks. Generally, we direct national banks to follow FASB policy.

It is true that income statements do not meet everyone's needs, because all sources of income and expense are not reported with the same degree of detail. Moreover, banks are not required to segregate their earnings and expenses into the kinds of categories some analysts would prefer to see. For example, we are aware of some interest in the separation of the sources of non-interest income into recurring and nonrecurring categories. We have not found a practical way to achieve that end because it is difficult to prescribe definitions that would effectively distinguish between those two categories for all banks. However, those who form and shape accounting rules for banks and bank holding companies, including the regulators, are rarely satisfied with the rules of the moment and are constantly trying improve them.

Because our method of supervision relies heavily on a highly trained workforce with many different skills, perhaps the most serious challenge the OCC faces is attracting and retaining experienced staff. Thanks to FIRREA, we have put in place a new interim pay plan, which is the first step toward making our compensation and benefits comparable to those offered by other bank regulators. We expect to make permanent changes in the next year, after careful study. This we believe will enable us to continue to build and maintain an examination staff that will be up to the challenges of the future.

One of those challenges will be ensuring that our approach to bank supervision remains effective. The banking industry is marked by rapid change and will continue to become more complex and competitive in the years ahead. Our method of supervision gives us the tools and the flexibility to respond to a rapidly changing industry. We are determined to take the fullest possible advantage of that flexibility by continually seeking to improve our analytic skills and the experience levels of our staff, with a heavy emphasis on appropriate training.

Enforcement

Enforcement actions are taken by the OCC after a careful case-by-case review of each proposed or possible enforcement action. The OCC does not attempt to set particular goals in terms of the number or type of enforcement actions it takes. As stated in the OCC's Policies and Procedures Manual, setting forth the Office's enforcement policy as of January 10, 1989:

> OCC will respond promptly and firmly to actual or potential problems in an individual bank or group of banks and [will] utilize its administrative enforcement powers consistent with the overall condition of the institution.

In addition, the policy specifically states that there will be a strong bias in favor of taking formal enforcement action when there is serious insider abuse, regardless of harm to the bank; when there are significant compliance problems or serious violations of law; or when the bank or the individuals involved have disregarded or have refused to respond to prior supervisory efforts to correct serious problems. As noted by the House Government Operations Committee Report on "Combating Fraud, Abuse, and Misconduct in the Nation's Financial Institutions", the OCC maintains a "vigorous enforcement program against insiders who abuse their positions or place their institutions in unsafe and unsound conditions."

Enforcement actions taken by bank supervisors can be both remedial and punitive in nature. Most are remedial. The OCC's enforcement actions are often similar to a road map, laying out specific guidelines to lead a bank back to a safe and sound condition. The severity of the enforcement action taken depends, in large part, on the commitment, ability, and willingness of the board of directors and management of a bank to deal with its problems. For example, in a bank where the board and management have recognized problems and are willing and able to deal with them, a written commitment by the board might be sufficient. On the other hand, when we detect a lack of ability or desire to deal with problems, we will take more severe action, such as formal Agreements or Cease and Desist Orders. We also have punitive enforcement actions at our disposal, which include the ability to assess civil money penalties and to suspend or remove officers or directors from a bank. FIRREA enhanced our enforcement authority, particularly with respect to punitive actions.

The OCC is committed to a careful case-by-case, analysis prior to taking any enforcement action. Such action should never be number-driven, or taken to satisfy quotas. However, the OCC's willingness to take strong and timely enforcement actions has been well-documented over the years. Between the beginning of 1986 and the end of last June, the OCC took over 1,600 enforcement actions, distributed by type as listed in Table 7.

TABLE 7

DISTRIBUTION OF ENFORCEMENT ACTIONS BY TYPE OF ACTION

Memoranda of Understanding	82
Commitment Letters	304
Agreements	415
Cease and Desist Orders	174
Removals	102
Civil Money Penalties (initiated)	559
Total	1,636

Source: OCC internal records (Data for 1/1/86 - 6/30/89)

The goals of the OCC in the enforcement area are the same as they have always been -- to utilize our enforcement authority as effectively, appropriately, and responsibly as possible. We will pursue all appropriate enforcement actions as part of our overall supervisory process to remedy unsafe and unsound practices or conditions or violations of law and to penalize and deter those who would engage in abusive practices.

SUMMARY

In conclusion, Mr. Chairman, the national banking system is fundamentally sound. That conclusion is based on a substantial increase in capital levels, especially equity capital levels, relatively strong earnings, and an improvement in overall credit quality among the majority of national banks during the past 18 months.

However, as I believe my statement reflects we are not without supervisory challenges. The economy of the southwest, recent developments in real estate markets, especially commercial real estate markets, and the continuing uncertain economic outlook of several LDCs pose risks for many banks. As a result, many national banks, particularly small banks in the southwest, will fail in the next couple of years. Many others will experience a fall in income and will need to augment their equity capital to withstand those earnings pressures. For our part, we, as bank supervisors, must strive to ensure that bankers are appropriately sensitive to those risks -- as demonstrated by their use of sound operating policies and procedures, by their provisioning for anticipated loan losses, and by their adding to equity capital.

As I stated earlier in this testimony, I believe the OCC has a supervisory process that will meet our supervisory challenges. Although we are always searching to improve it, we believe it keeps us apprised in a very timely way of the performance, policies, and procedures of each of our banks. It calls upon us to take prompt and specific actions when we find deficiencies. We take our supervisory responsibilities very seriously and are committed to providing supervisory processes that will ensure the continued safety and soundness of the national banking system.

ADDENDUM ON BANK CAPITAL

THE OCC'S PROPOSAL TO AUGMENT RISK-BASED CAPITAL WITH A 3 PERCENT TANDEM LEVERAGE RATIO

The OCC has recently proposed to augment the minimum capital levels permissible for national banks under the risk-based capital standard, which becomes effective at year end 1990. We have proposed a minimum tandem leverage ratio mandating that national banks maintain core capital of at least 3 percent of total assets. This is in addition to the risk-based capital guidelines, which require that core (equity) capital be equal to at least 4 percent of risk-weighted assets and total capital be equal to at least 8 percent of risk-weighted assets.

Our emphasis on risk-based capital illustrates the OCC's belief that the capital requirements for each bank should be linked directly to the riskiness of the bank's activities. Thus, we believe a bank's minimum capital requirement should vary as the bank rearranges its portfolio into activities with different levels of credit risk. However, we recognize that regardless of the amount of risk in a bank's portfolio, some minimum level of capital is necessary because each bank is exposed to other risks, such as those from operations and interest-rate swings. The proposed 3 percent tandem leverage ratio provides for this minimum level of capitalization, but it is not so high that it compromises the risk-based capital minimum.

The risk-based capital requirements strengthen capital standards over our current capital standards in two fundamental ways. First, they increase capital requirements for banks engaged in riskier activities without forgoing the safety provided by a minimum amount of equity capital. Second, they redefine capital and set minimum requirements in terms of equity, rather than primary capital. The new capital guidelines will require that banks engaged in riskier activities and with more off-balance sheet commitments have a larger capital buffer than banks not engaged in those activities. We estimate that almost 700 banks with over 40 percent of all bank assets would not meet risk-based capital requirements if they were fully in effect today. If these banks make no changes in their portfolios, they will need an additional $23 billion in capital to meet the risk-based rules, including the 3 percent tandem leverage ratio. In contrast, it would take only an additional $2.2 billion in capital for all banks to meet the current capital standards. It is important to note that most banks today exceed present capital minimums, either voluntarily, or because bank supervisors have insisted that they do. Under the new guidelines, most banks will be expected to continue to operate with capital levels well above the regulatory minimums.

ABA Bankers News Weekly

Opinion Article by Robert L. Clarke
Comptroller of the Currency
October 5, 1989

Who would have thought that bank capital could be a hot topic for public debate?

Last winter, after three years of work, all three federal bank regulators adopted risk-based capital standards that will go into effect at year-end 1990. Few people outside banking paid much attention. At almost the same time, the bottom was dropping out of the thrift industry. All of sudden, the public -- and Congress -- began to focus on the importance of capital -- for banks as well as thrifts.

Under the risk-based rules, banks will be required to hold at least 8 percent capital against risk-adjusted assets. That's the minimum -- the regulators could require more. The lower the risk in a bank's portfolio, the less capital it will have to hold. At the same time, however, all the regulators recognized that banks need protection against other kinds of risk -- interest rate risk, operating risk, etc. And we all agreed there should be a floor capital requirement for all banks, even those with only minimal risk in their portfolios.

The OCC is proposing that the floor requirement -- the so-called leverage ratio -- be 3 percent, entirely made up of tangible capital. We believe that this floor, which would go into effect at year-end 1990 in combination with the risk-based guidelines, will do *more* than the current 6 percent total capital requirement to ensure the safety and soundness of the banking system and protect the FDIC insurance fund.

First, the new capital standards will require more banks to raise capital than the current rules and will require more capital in the banking system. About 50 percent more banks do not meet the risk-based requirements today than do not meet the current capital requirements. The total amount of capital required for all banks to meet the risk-based rules, including a 3 percent leverage ratio, would be $209 billion, compared to the $185 billion required to meet current capital standards.

Second, under the risk-based standards and the 3 percent leverage ratio, banks that pose the greatest potential threat to the FDIC insurance fund will be the ones that must raise additional capital. Ten percent of the banks in this nation hold 70 percent of the assets in the banking system. For the most part, it is these banks that will have to raise additional capital.

Some critics have noted that the risk-based rules with a 3 percent leverage ratio would permit about 90 percent of the banks in the country to decrease their capital ratios. That is true. It is also true that if the leverage ratio were increased to 6 percent, more than 50 percent of the banks in this country could decrease their capital ratios. And under the current rules, 95 percent could lower their capital. All these numbers are essentially irrelevant, because they ignore one important fact: risk-based capital ratios require hard tangible capital, while current capital ratios do not.

Moreover, among the banks that could theoretically lower their capital under the new rules, the current average primary capital ratio is over 10 percent -- well above the regulatory minimum. Ninety-seven percent of these banks have assets under $300 million. We do not expect these banks to lower their capital levels simply because they would exceed the guidelines.

History supports this expectation. In April 1985, the minimum primary capital ratio for community banks was lowered from 6 percent to 5.5 percent. But, by the end of 1986, more than half these banks had increased their primary capital ratios.

But perhaps the most difficult -- and potentially damning -- criticism of the 3 percent leverage ratio is the charge that it represents a weakening of bank capital requirements. The trouble is that this criticism appears so simple. After all 3 is less than 6 -- or is it?

Are three watermelons less than 6 grapefruit? It all depends on what you're trying to measure.

The fact is that all of the current 6 percent total capital requirement can be made up of loan loss reserves. The current rules have no minimum requirement for equity capital.

That's one reason we redefined capital under a risk-based system to require equity capital. That's also why we proposed a 3 percent floor under risk-based capital -- 3 percent that would have to be made up of the hardest, most tangible forms of capital.

Every national bank would have to meet both the risk-based capital guidelines and the 3 percent leverage ratio. A bank that satisfies one but not the other would have to either raise capital or adjust its portfolio. And, under our proposed rule on insolvency, if a national bank exhausts its equity capital, we will close it.

A 3 percent leverage ratio -- in conjunction with risk-based capital -- represents a toughening of bank capital requirements, not a weakening.

Perhaps equally important, risk-based capital requirements, including a 3 percent leverage ratio, will permit U.S. banks to compete for the first time on equal footing with their counterparts overseas. A 3 percent leverage ratio would allow the risk-adjusted guidelines to work, while at the same time protecting the safety of the national banking system. Higher or lower minimums would result in one or the other of these goals being compromised. Either you have a risk-based capital system, or you don't. There's no middle ground.

All the federal banking supervisors agreed to guidelines creating a risk-based capital system, and we should all allow that system to work. For more than three years, we debated whether risk-based capital is preferable to what we have now. We all decided the answer is yes. That being the case, we should get on with its implementation.

# # # # #

The CHAIRMAN. Thank you.

Senator Graham has come in.

Do you have an opening comment?

Senator GRAHAM. I do not have an opening statement, Mr. Chairman. I commend you for having this hearing as part of a series on the health of our financial institutions and look forward to questions to the panelists.

The CHAIRMAN. Very good. Thank you.

Chairman Seidman, in your testimony, and I quote you, you say as follows:

> The Comptroller's current proposal would reduce the required minimum amount of capital in the banking system by at least $8 billion.

And then you go on to say:

> Almost 10,000 banks would be able to reduce their equity capital.

Can you elaborate as to how you have arrived at these conclusions? And give us more of a sense as to what I take to be concern about that?

Mr. SEIDMAN. Our approach was really simple. We took the Comptroller's proposed standards as they would be when fully in effect, two standards, one risk-based and the other what he calls a tandem leverage ratio, or the leverage ratio, and we ran for all banks how much capital they would be required to have under that standard.

We compared that with the current standard. And so we had two numbers for each bank. One number was what the new standard would require, and the other number was a dollar number of what they are now required to have.

And we found that a reduction in that standard would be applicable to about 10,000 banks, primarily the smaller banks.

Let me just say in addition, all the good things that the Comptroller says about what he wants to do, we agree with because we agree with everything that he wants to do. We just want to do more. We want more capital than his standard provides for.

There is no way that our numbers can be less than his because we are agreeing to everything that he wants to put in place, and we are providing an additional standard. And we are suggesting that there be an additional standard.

So, I think it is quite clear that his numbers couldn't result in greater capital than ours because we are assuming his standards to begin with.

The CHAIRMAN. Now, as I understand it, just so the record is clear, in terms of what the Comptroller is proposing, you are supportive of that but you feel that it doesn't go far enough. You think additional higher levels of capital are required. And do I take it from your comment as well that you put a particular emphasis on equity capital?

Do you mean to do that? Are you saying that you want shareholder money in a greater percentage amount regardless of what other kinds of assets there are here, as a protection?

Mr. SEIDMAN. We are saying first and foremost we don't want 9,844 banks to refigure their capital and find out that the standard has been lowered for them.

We think, therefore, there should be an addition above the 3 percent core capital which has been suggested, which would be second tier capital, as defined in the risk-based standards. That would bring us to a point where these 9,000 banks would not have a lower capital standard.

It is all very complicated when we start talking about all of this, but I have to say that it comes down to the fact that we all agree that there had to be two standards—risk-based is not enough. The Comptroller has made that point.

The international organization is now studying risk-based to add additional standards to deal with the kind of problems that we are dealing with, so they haven't even completed their work.

Given all of that, it seems to us that it is not a good time to allow the majority of banks, mostly the small ones, to have a reduced capital standard.

The CHAIRMAN. Mr. Clarke has testified that the 3 percent would, in his words: "Destroy the risk-based capital standards."

Is there a conflict here that he is eliminating that we really need to take account of on that point or not?

Mr. SEIDMAN. Well, I think yes. That goes to the key question of the purity of the risk-based standard being so important that, in order to use it, we will allow very substantial numbers of banks to reduce their standards.

When you get right down to it, the risk-based standard doesn't work by itself. So the question is what, in addition to the risk-based standards, do you need? Since we all agree it doesn't work by itself.

What we are saying is that the addition ought to be enough so that we don't change the present standard to reduce capital for the majority of banks in the country.

The CHAIRMAN. Mr. Clarke, do you want to react to what has just been said?

Mr. CLARKE. Yes, Mr. Chairman, I would be pleased to.

I think one of the things that is unfortunate about the statement that 9,000 banks or 10,000 banks could lower their capital under the risk-based standard and our proposed tandem leverage ratio is that it is very misleading. It is absolutely true. But, if you look at the facts, you will find that 95 percent of the banks in the country could lower their capital ratios from where they are today.

Now, why do you suppose they haven't done that? They haven't done it because the vast majority of the banks want to operate at higher levels of capital, have always operated at higher levels of capital, and did not lower their capital ratios when the rules were changed back in 1984 to the 5.5 percent/6 percent level.

And, second, they haven't done that because we require a lot of banks to operate at higher levels of capital. As Vice Chairman Johnson indicated earlier, quite often in connection with mergers, acquisitions, and normal supervisory activities, we require banks to operate at higher levels of capital. If history repeats itself, the banks are not going to lower their capital ratios below their historic levels.

The other thing that I think is unfortunate is that you talked about $8 billion coming out of the system. That assumes that you are going to put in place a 6 percent leverage ratio; that is quite different from what we have today. The 6 percent requirement that we have today consists of primary capital, all of which can be represented by the loan loss reserve. All of us agree that that is not a good idea, and that is why $24 billion of new capital has to go into the system under the risk-based guidelines and the redefinitions of capital, with our 3 percent tandem ratio. $24 billion of new capital into the banking system does not sound to me like a lowering of capital.

The CHAIRMAN. Well, my time is up. And I'm not sure we have exhausted this subject.

Mr. SEIDMAN. I would be glad to respond.

The CHAIRMAN. Know that we will today. But, if I may, you are shaking your head so I had better see what that was inferring.

Did you want to make an additional comment before I——

Mr SEIDMAN. Go ahead. That would be all right.

I just think, if the Comptroller makes the point that banks retain capital above the minimum, then we don't need any standards. We are not talking about how banks—we are talking about the minimum for those who don't behave in the way that we would like them to. And we are saying that you are giving the opportunity for 9,800 banks to lower their capital and still meet the minimum standards of the government.

So, to say that they hold more capital now than they are required I think simply doesn't address what we are talking about as the minimum standards. It is very simple. We are insurers. We want that $8 billion between us and having to pick up losses.

There is no argument that there is $8 billion that will be there under one standard and not there under the other.

The CHAIRMAN. Now, is there some way, Mr. Comptroller, that you could find to try to satisfy the concern that Mr. Seidman has? Or do you feel it is not a valid concern?

Is there some way to get the best of both worlds here so that we don't backslide? Is there some way to resolve that concern or not?

Mr. CLARKE. There are several things that I think help the insurer. One is that we would make absolutely clear, as we always have in the past when capital standards have been adopted, that we are talking only about minimums. We would stress that historically banks either have chosen to operate with higher than minimum capital or have been required to and that we would continue to expect banks to do that.

Second, we are going to do something which I think materially enhances the protection of the insurance fund. We are going to change the definition of insolvency for national banks so that when a bank runs out of equity capital, it is insolvent and can be closed. Under our present standard, we have been closing banks when they become primary capital insolvent, which means that, as long as they have a loan loss reserve or some form of soft capital that counts as primary capital under the current definition, they are not deemed to be insolvent. Arguably, we have the authority currently to close them sooner, but we are going to make it absolutely clear and have given notice that we are changing the definition of "insolvency."

When you relate capital standards to the riskiness of the bank's portfolio as the risk-based guidelines do, when you supplement that with the tandem leverage ratio, which is pure equity capital, and when the bank runs out of that equity capital you shut the place down, that does more than anything I can think of to protect the insurance fund from losses.

The CHAIRMAN. We could continue, but let me yield to Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I would categorize the message that you, the three of you, delivered to us this morning in the sense of:

Don't worry. Be happy.

But, the more that I listen to your testimony, we talked about the number of bank failures where they might be running—I don't know—close to the same rate as last year. Maybe, slightly less.

We talked about the problem assets of real estate loans and LDCs, leverage borrowers, the loss last year in the FDICs, some $4 billion. And then talking about the need to increase capital.

It says to me that we do need to be concerned, but maybe I missed some of the thrust of your messages, and maybe each one of you might want to just address that again for me to see where I missed the point.

Mr. CLARKE. I don't think you missed the point. If I could respond, I think that most of us are happy, but we are worried. And, as indicated in our written statement, there is good reason for that.

But the capital issue goes to the broader theme which underpins the FIRREA legislation that the House and the Senate both adopted and the President signed. That is that we don't want what happened in the thrift industry to happen again. I think the formula for keeping it from happening again is to have strong supervision, to have real capital standards, and to shut down institutions when they become insolvent. I have already addressed the insolvency aspect; the strong supervision aspect is addressed in some detail in my written statement. Real capital is the third aspect. And, we are moving to an era where real capital or cash is king.

Senator MACK. I notice in the testimony that there is an increase in the percentage of capital aspects. Could you give me some indication of where that capital came from? What type of capital is it?

And, again, in the testimony, I don't want to say there is good capital and bad capital, but there certainly is stronger capital than——

Mr. CLARKE. A lot of it is retained earnings, which is equity capital. A lot of it came from equity capital raised in the capital markets as banks worked to get themselves in a position where they meet the risk-based guidelines by year-end 1990.

One thing that people forget about the risk-based guidelines is that not only do they relate capital to the riskiness of a bank's portfolio, but they also redefine capital. They say that banks can no longer meet the primary capital requirements through the loan loss reserve alone. Half of a bank's 8 percent capital to risk-adjusted assets has to be in pure equity capital. That is why these banks are scrambling to raise capital.

Mr. JOHNSON. I think what we are all saying is that we are relatively happier than we were in the past when there seemed to be even more complex problems associated with the banking industry. I would have to say that there are still problems in the banking system, and I think that we tried to point that out.

There is no doubt that the real estate problems, LDC debt, and LBO financings all simply still represent the problem areas in the banking system which don't appear to be going away in the immediate future.

Nevertheless, capital ratios have been improved and earnings do appear to be better than they have been for some time, even though actions to increase reserves have recently been taken by the major banks in the third quarter this year, which will reduce equity capital for the largest banks.

In some ways, that will work to insulate the banks from the LDC debt problems that existed before, and it actually sets the stage for improved earnings in the future.

I think we now can look back on the reserving process and say that most banks are adequately reserved against the LDC risk for the first time.

In that sense, the banking industry is in better condition. But we still think that there is a shortage of equity capital in the industry.

Senator MACK. Let me get you to address for a moment the leverage buyout. I think you mentioned in your testimony, maybe in the written portion of it, that there has been an increase of something like 20 percent to leveraged borrowers. And there's been a fair amount of debate during this past year as to whether the Congress should play a role in restricting that kind of lending, and discussions about what causes it.

I happen to have a feeling that it is because of tax laws that place a greater incentive for borrowed funds as opposed to capital, that if we were to address things like the double taxation of dividends, the lowering of capital gains, that we might, in fact, shift the desire for borrowed to capital.

I would be interested in your response.

Mr. JOHNSON. There clearly is a bias in the tax system towards debt, that is absolutely true, because we do allow the deductibility of interest on borrowings to finance activities, and we double tax dividends.

So there is this bias that I think should be corrected. Many interest deductions are legitimate business expenses. Some, however, have been less justifiable, and the Tax Reform Act of 1986 tried to deal with some of those.

But, clearly, the double taxation of dividends penalizes equity. There is no doubt about that.

But, having said that, I'm not sure about how much of the problem you can attribute to that even though there is this clear bias because that bias has been on the books for a while. I think that the culture has changed and financial instruments have changed and these innovations have made it more possible to conduct leveraged buyouts.

In many ways, the process is even constructive. I don't think corporations should be country clubs. They shouldn't be insulated from the takeover process, but at the same time, we don't want to overly encourage the leverage process as a means for financing these takeovers.

Because of this, we have set guidelines for the banking system that require them—the banks—to avoid making the most extreme forms of loans to the most extreme forms of leveraged financing that require asset sales for the servicing of debt.

But there are pluses and minuses to this process.

The **Chairman**. Did you want to extend your time to see if Mr. Seidman wants to respond?

Senator **Mack**. Fine.

Mr. **Seidman**. The first question, Senator, I would respond that we said in summary the health of the banking industry is acceptable. I think that is about what you can say about it. It is acceptable, not that it is good. It is improving. In my view, it needs more capital.

I agree with Governor Johnson in that respect.

Certainly, with respect to your second question on the LBO's, I think it is important that we change the tax system. I have been working with some members of the Ways and Means Committee on a system that would neutralize the tax effects, hopefully, without too great a loss of revenue. And lots of other people are working on that.

I hope that a system that encompasses that will be put forward.

The **Chairman**. If I may say before yielding to Senator Graham of Florida, that a lot of people are, in fact, working on that. I have been working on that with a team of people, too. We have examined the effect of the 1987 tax changes as they come into behavior on corporate asset structure and the tilt toward equity versus debt, or in this case, toward debt versus equity.

The debate on the Tax Reform Bill took place on one-dimensional level. It is clear now that other second and third dimensional effects were set in motion that I don't think we ever debated or foresaw, which have, in effect, created an enormous tilt toward debt financing and given a huge shot emphasis in the direction of the leverage buyout activity, which was already well underway.

There is a very powerful analysis that demonstrates it.

Now, what do we do about it to try to get back, as I think many people want to, to something that at least puts equity on equal footing with debt. It is easy to state the point. It is much tougher to figure out how to get from where we are to that point without tipping things upside-down and so forth.

Just one other comment.

And that is, it sounds to me that instead of:

Don't worry. Be happy.

You are recommending that it change to:

Do worry. Be happy.

I'm not sure if that is the second step, what the third step is. What follows "Do worry, be happy"?

Does that mean that at some point up the road we are going to be saying:

Yes, we really needed to worry and now we're not so happy?

I'm not quite sure where "Do worry, be happy" leads us.

Senator **Graham**. Thank you, Mr. Chairman.

During our consideration of the thrift industry, an issue that many of us thought was a fundamental error was the merger of FSLIC and the Home Loan Bank Board, so that the same group of people were looking at the underwriting insurance decisions as were looking at the regulatory, chartering and other issues.

Mr. Seidman, to what extent do you have the ability to impose underwriting standards that are independent from and different than those that the Comptroller of the Currency is suggesting?

Mr. SEIDMAN. Insofar as capital standards are concerned?

Senator GRAHAM. Yes.

Mr. SEIDMAN. Well, the Comptroller is authorized to set standards for national banks and we have, therefore, no control over the standards that he sets. That standard is also used in new legislation as a minimum standard for thrifts.

So, to the extent that he exercises that power, our only power would be to remove insurance if the particular institution was operating in an unsafe and unsound manner.

But, normally, by the time that happens, standards don't make much difference because they are below anybody's standards.

Senator GRAHAM. Do you feel that FDIC should have any independent capacity to supplement capital standards based on FDIC's responsibility as an insurer?

Mr. SEIDMAN. I think we have an important interest in capital standards. I think it is said that we have not been able to agree between us after many long, long discussions.

I am unhappy about it. We have suggested compromises. We did agree tentatively on a compromise which was not finally agreed to. I really think that if we can't have three different standards in the banking system, and if we are not able to agree, then I must say that, as much as I dislike to say it, the Congress will have to get in it and decide it for us.

Senator GRAHAM. You are in deep trouble.

Mr. SEIDMAN. I know. That's why I hated to say that. Or, maybe the administration can do it.

Senator GRAHAM. I believe in the theory that not to decide is to decide. And in this case, the Congress has made a decision which is that the Comptroller of the Currency will have ultimate and final responsibility over capital standards. And that FDIC will accept those standards as being sufficient for its underwriting purposes.

Mr. SEIDMAN. No, that has not been determined, Senator. I would have to disagree with you. The statute only provides—they set standards for national banks. We are the primary regulator for State nonmember banks and we set standards there.

Senator GRAHAM. So the statement I made overstates when it goes beyond the national bank.

Mr. SEIDMAN. Yes. I mean, he has the authority over national banks and we have the federal authority over—we are the primary regulator of State nonmember banks, approximately 8,000 banks, most of which are in these 9,000 that would have their capital standard reduced.

Senator GRAHAM. In the thrift bill, there was a directive both to FDIC specifically and then as part of an overall study which is composed of multiple agencies and individuals, the issue of risk-based insurance premiums, that it be reviewed—that they be reviewed.

Can you tell us what the status of that study is and what questions you think that study will answer?

Mr. SEIDMAN. We have long asked for the authority to levy risk-based premiums. It is a very difficult thing to do because determining risk in advance means that you have to predict the future.

And none of us are totally able to do that. So the standards would have to be tied to some kind of numerical standard so that they wouldn't be judgmental. That is a difficult task.

Nevertheless, we think that we could improve the system with that. We have submitted our views to the Treasury, which is conducting the study. And I assume that there will be lots of others who will submit views on that.

Senator GRAHAM. Do you believe that, if you had the power to utilize a risk-based insurance premium concept, that that would moderate your concern relative to capital standards by giving you the alternative of changing the cost of premium to those institutions which you felt did not meet a norm of safety?

Mr. SEIDMAN. It certainly would help. I agree with that. But I don't think it exactly addresses the problem. Our position is very simple and that is that we would prefer to have minimum standards put more capital between us and losses. Not less.

Senator GRAHAM. Thank you, Mr. Chairman.

I have some questions on another subject for the next round.

The CHAIRMAN. Very good.

Senator Gramm.

Senator GRAMM. Mr. Chairman, let me begin with a general question, because I get lost in all of this stuff about whether I ought to worry or whether I ought not to worry. I have never found worry to be very productive, and I prefer being happy.

Let me just try to be sure that I've got everything in perspective. I will pose a couple of simple questions.

Number one, and I will ask it to all three of you:

Is the basic financial structure of the American economy, including banks and savings and loans, stronger today than it was a year ago? Is it weaker? Is it about the same?

Why don't I start with you, Mr. Seidman?

Mr. SEIDMAN. I believe it is stronger.

Mr. JOHNSON. I think it is stronger, but far from perfect.

Mr. CLARKE. And I think it is stronger also for all the reasons discussed in my written statement.

Senator GRAMM. Now, based on what we are looking at in the economy, based on what you are undertaking in each of your agencies, do you expect the financial structure of the American economy to be stronger a year from now than it is today?

Mr. SEIDMAN. Based on what we can see and, of course, that depends on the future economy, but given our current predictions, we believe that it will be stronger.

Mr. JOHNSON. Yes. I think the chances are good that if we maintain our commitment to keeping inflation down at the Federal Reserve and, at the same time, are sensitive to continued expansion in the real economy, that the situation will be improved.

Mr. CLARKE. I would agree with that to the extent that the underlying assumptions about the economy are as Vice Chairman Johnson indicates. But I cannot resist the temptation to include in that answer, whether the timeframe is a year from now or 2 years from now or 5 years from now, that I am very concerned about the banking industry in America maintaining its ability to compete without the Congress taking action to break down some of the barriers that I believe stand in the way of that ability.

Senator **Gramm**. I will make my next question a short-answer one as well:

If our objective in the Congress is to strengthen the financial institutions of the Nation, to make them more viable, more competitive, stronger, more secure, what, in short answer form, are some of the things that we could do so that 1 year from now, 5 years from now we would see a stronger, more competitive, more stable financial structure?

Mr. **Seidman**. In a sentence, provide that the institutions have a broader—compete on a broader line of products and that they can raise capital from a broader constituency than they are now allowed to.

Senator **Gramm**. Now, in the terms we use, would that be a movement toward more regulation or more opening up of competitiveness among institutions?

Mr. **Seidman**. It would allow more competitiveness. It would still require, as I've said many times, more supervision.

Mr. **Johnson**. Well, I agree to some extent. I think that broadening the powers of organizations is important to add to the financial strength of the banking system.

However, I want to emphasize especially that how that is done is absolutely critical. A great mistake made in the thrift industry was allowing thrifts to expand into almost any type of activity with absolutely no constraints on how they accessed insured deposits.

And, in many ways, thrift institutions were allowed to engage directly in real estate development through the use of insured deposits either through subsidiaries of the thrift institution or directly in the thrift.

And I think that set-up was destabilizing and explosive for a financial environment. If you're going to do it right, in my opinion, the structure has to be to, sure, allow expanded powers, but maintain a strict separation between the financial safety net and these non-bank activities.

That means walling off the bank itself from the rest of the nonbank financial services industry, so that you protect the safety net adequately.

And, to me, the only way you can do that is through a holding company structure.

Senator **Gramm**. Let me just inject here that I agree with you. I think the savings and loan problem really came about when Congress gave savings and loans massive new powers, in part, to bail them out of the financial problems they were in during the late seventies, and then left their regulation to a sleepy little institution that had been regulating home lending in an inflationary area where only an idiot could lose money making loans on houses.

And, suddenly, these institutions were in the residual earners in the fried chicken business.

So, in a sense, what you are saying, and I strongly agree with it, is that more competitiveness, more deregulation puts a heavier burden on the regulator.

Now, let me have Mr. Clarke answer.

Mr. CLARKE. Senator, it puts a heavier burden on the regulator in a sense, but as Vice Chairman Johnson and Chairman Seidman have indicated, the way that you bring about deregulation is by creating a structure that protects the safety and soundness of the institutions that have the benefit of the safety net but still allows them to take advantage of other opportunities. If you fashion a system that relies on functional regulation, you are not really creating a greater burden for the banking regulator because you are letting the regulators that regulate those other businesses deal with them. The securities activities, for instance, would be dealt with by the securities regulators, not by bank supervisors. But the real punch line in all of this is that you do have to have strong supervision, and you have to satisfy yourselves, I think, that that exists.

The CHAIRMAN. Thank you.

Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. I wanted to follow up with a question that Senator Mack asked about LDO's and I think the response was basically:

We are looking at the tax side of the equation.

My question to the panel is:

What about the regulatory side? At least from some of the reports that we see, and a good bit of the commentary that we read, there are some potential major problems that may need to be focused on, not just prospectively from change in tax policies, but a more aggressive regulatory approach.

And I would like to get the response of the panel to that question specifically.

Mr. SEIDMAN. Well, I think all of us have taken special notice of this problem and issued special supervisory rules in essentially looking at whether the LBOs are being handled in a way that prevents concentration, that are on terms that would be normal banking terms.

Most cases, I think we have found, at least most banks are handling them in an appropriate way. But that does not mean that every bank is.

And so they are a matter of concern and I think all of us have taken actions to look at those particular kinds of assets.

Senator BRYAN. Mr. Clarke or Mr. Johnson, do you care to amplify that?

Mr. CLARKE. Senator, I have explained at some length in my written statement the measures that we have taken over the last year and a half in dealing with these transactions. This is something that we have been on top of I believe from the very beginning of the problem, if there is a problem.

As Chairman Seidman indicates, we feel that, by and large, banks are managing their exposures fairly well. That is not to suggest that there will not be some losses. It is important to remember when you deal with the supervision and the regulation of these types of transactions that they are fundamentally loans. They are loans that involve higher levels of risk. That is why we require banks to deal with them more carefully. But they are, after all, fundamentally extensions of credit.

Senator BRYAN. Mr. Johnson.

Mr. Johnson. I don't have anything to add, Senator.

Senator Bryan. I think, speaking for this Senator and perhaps others on the panel, having just gone through the agony of the savings and loan bailout and having at least heard the testimony before this Committee, although not a member of the Committee at the time, that there was really no great cause for alarm or concern, testimony that was offered 18 months to 2 years ago, and then seeing this problem of the magnitude that we have dealt with, that the $169 billion may not be at the bottom.

And as much as you all know and are personally involved with, it suggests that it may be far greater than that.

I would like to get some sort of assurance from you that the LBO problem is under control, that we are not going to see it develop into a problem that threatens the solvency of the banking system, so that we are looking at a similar type of a congressional bailout a year, 2 years, 3 years down the line.

And may I have a response?

Mr. Seidman. My first concern would be outside the banking system. The riskier parts of an awful lot of these LBOs are in insurance companies, pension funds and other places. I think the level of risk there, since they are the downstream or the more risky securities, is high and could clearly be, and perhaps is already, a problem for some of these institutions.

The banks of course will reflect some of that, but I think the larger problem as we look at it now is likely to be beyond the banking system and other financial institutions.

Senator Bryan. Mr. Seidman, I understand that these are relative levels of concern, but I guess what I want to hear from you, if true, is that you ought not as a member of this Committee be spending any sleepless nights worrying about LBOs and the banking system, that we have got that under control. That there may be isolated problems, but that it does not constitute a threat to the banking system that needs to involve this committee directly in terms of oversight responsibilities.

Mr. Seidman. I think the committee should keep very close oversight on the question at this time. However, from the institutions we look at, I don't think that it is a threat to the banking system.

Mr. Johnson. I agree with that. I think we have put in place very prudent standards for banks in terms of their lending practices for leverage financing transactions. And so I am quite comfortable with the current standards we have in place in the banking system. As Chairman Seidman pointed out, that is not where all of the financing takes place by any means. And like anything in a system like ours, there are going to be winners and losers from transactions like this as part of the overall discipline. Some of the more extreme cases are having problems and realizing that there are limits to this.

And so I don't even think protecting a system from every single transaction is what we want to do. That is even part of the discipline in the process.

But, as far as the banking system goes, I feel quite confident that we have prudent standards for banking institutions.

Senator Bryan. I would hope, and I see my time is about ready to run out, that if something should change on the horizon, that you would come before this committee and say, Look, we need your help. We need to have you do this or that or whatever needs to be—that this committee needs to be informed of, rather than us looking retrospectively at the problem and being forced to raise billions and billions of dollars and saddling that burden on the American taxpayer because that is precisely, as you all know, what we did with the savings and loan industry.

And, very frankly, the public doesn't understand that. They will never understand it. It is very difficult, I think, for the members of this committee that did the responsible thing, that this problem would have been much, much less, much more easily managed and addressed if we had had a far more aggressive response from the regulators. And a request for timely assistance.

Thank you very much, Mr. Chairman.

The **CHAIRMAN**. Senator Bryan, I wonder if we should get Mr. Clarke as part of the certification. You can two-thirds of the way down the table, but I think, for the record, we don't want to leave Mr. Clarke out of it. And I'm sure he would not want to be left out of it.

Mr. **CLARKE**. I think you should keep asking us about them. But my belief is that, at this time, they do not pose the kind of threat to the system that you are describing.

Senator **BRYAN**. Thank you.

The **CHAIRMAN**. Senator Bond.

Senator **BOND**. Thank you, Mr. Chairman. It is a pleasure to have these distinguished witnesses before us today, and I thought I would start off with an easy question.

Gentlemen, the American Bankers Association has begun to raise some complaints about the banking industry's regulatory burden, arguing that the cumulative weight of all of the reporting requirements and regulations is strangling the industry.

I would like your views on whether that complaint is valid, whether there is anything that can be done about it administratively, or whether we ought to be considering something be done legislatively if, in fact, there is a danger.

Let's start with Mr. Clarke on this end.

Mr. **CLARKE**. Senator, the Association has raised a valid point.

I do think it is important to keep in mind what gives rise to a lot of those regulations, and that is the laws that require the regulators to promulgate regulations. Sometimes it is easy to overlook their cumulative effect. You think you have identified a problem, and it is probably a legitimate problem. You pass a law to deal with it and get the regulators to adopt some regulations. But, it is kind of like the professor who thinks that a student takes only one course and forgets there is a cumulative effect.

I think that it is appropriate every now and then to stop and tote up the burden and ask if there is some way that maybe we can pare some of this back. Is it really cost-effective? Do some of these things really accomplish the purpose for which they were intended? We intend to take seriously what was presented in that report and see if there is anything that we can do administratively within our own organization.

Mr. **JOHNSON**. I agree with that point. I don't have anything else to add.

Senator **Bond**. Chairman Seidman.

Mr. **Seidman**. I would add one statement. I think a tremendous amount of the burden is involved in consumer protection type legislation. And I think that every time we move in that direction, we have to weigh the cost which ultimately the consumer pays against the kind of protection that we are giving them.

Otherwise, I agree with what has been said.

Senator **Bond**. I would like the views of all of you on another question. If you were writing the 18-month study of deposit insurance that the Treasury Department is now working on, what changes would you suggest?

Mr. Seidman?

Mr. **Seidman**. We put out a study, Senator, called Deposit Insurance for the 1990's, which summarizes our views on that matter. I can just think of one of them now, and that is whether deposit insurance protection should be changed or reduced.

We have addressed that by saying that it is very difficult to deal with that issue until you deal with the issue of protecting large bank depositors when there is a failure. Because if, in fact, we do that and every developed country in the world does that, then, for all practical purposes, they have 100 percent deposit insurance.

If they do, then treating smaller banks in terms of reducing insurance will put them in an important competitive disadvantage.

So I guess my basic approach would be:

Let's look at this too-big-to-fail doctrine. If it needs to be changed, then we can change deposit insurance protection. Otherwise, I don't think it will be meaningful.

Certainly, from the insurance fund, the costs are in the too-big-to-fail operation, not in the 100,000 against 90 or 80 thousand for smaller institutions.

Mr. **Johnson**. I agree with Chairman Seidman on that. We are still studying, of course, what to recommend on the deposit insurance reform. But there are some issues that I think have come up that we look favorably on.

But I agree. You have to resolve the too-big-to-fail issue at the same time that you deal with the degree of deposit insurance because for many of the large institutions, they really don't have insured deposits.

Some of the largest banking organizations are wholesale type banks that don't take insured deposits. And the amount of insured deposits relative to total liabilities in large banking institutions is relatively small, so it is more than just insured deposits. It is the too-big-to-fail issue and the question of how we are going to resolve that.

My personal opinion is institutions shouldn't be too big to fail. That discipline has to be in place. But, exactly how you apply that standard needs to be well thought out.

If deposit insurance is going to be in place, we also support the notion of early closure of financial institutions. More early closures along the lines that the Comptroller suggested would be associated with the fall in equity capital, and the institution would be subject to conservatorship and closure before it became insolvent on an equity capital basis.

We also like the concept of risk-based, deposit insurance premiums if it can be made practical. And all of these are types of changes that I think would help add discipline to the financial system.

But the most important things are resolving how much deposit insurance and the too-big-to-fail question, because those are the central issues.

The CHAIRMAN. Did you want to pursue that?

Senator BOND. Could we have Mr. Clarke's answer?

The CHAIRMAN. Yes, of course.

Mr. CLARKE. Senator, I don't want to use up all the rest of your time, but——

Senator BOND. It is already gone. Take as long as you want. It's on someone else's now. [Laughter.]

Mr. CLARKE. I would simply say that, as a general principle, I would put the emphasis not on tinkering around with deposit insurance as such—there are various theories that have been suggested for doing away with deposit insurance or reducing the amount of insurance or making it a co-insurance system—because I think deposit insurance provides a very important underpinning to the stability of our financial system. I think the focus instead should be on how we operate in an environment where there is deposit insurance, on the kind of structures that we create for our financial services that have deposit insurance associated with them?

And on the kind of supervisory processes needed to protect the Fund.

Senator BOND. Thank you, gentlemen.

I thank you, Mr. Chairman.

The CHAIRMAN. Senator Sanford.

Senator SANFORD. Thank you very much, and thank you for being here.

I think we probably have examined about as fully as we can the LBO and hostile takeover financing, which continues to be a serious problem.

Let me move to another general question.

We developed here a rather extensive piece of legislation broadening the powers of banks, primarily to give them an opportunity to compete internationally.

Now, we have been so busy this year dealing with the S&Ls, bailout, housing issues and other matters that simply demanded the attention of this committee, that we haven't turned our attention back to what we obviously thought was extremely important considering the time we spent on it. And almost everybody signed off on it.

Now, shall we move back to that?

Is the process of the regulators broadening the powers procured in a proper manner? Or should we turn our attention back to that banking legislation?

Let's start with Mr. Clarke?

Mr. CLARKE. For my part, Senator, I definitely think that you should turn your attention back to that. There are certain things that the bank supervisors can do by way of broadening competitive opportunities for banks. But they are very limited. I think a lot of what has to be done will have to be done by the Congress, and I would encourage you to do that.

Senator SANFORD. Mr. Johnson.

Mr. JOHNSON. I agree with that point. We've always thought it would be preferable for Congress to rationalize this area. And I think that we continue to encourage expanded powers for banking organizations.

But I want to emphasize like I did with Senator Graham, we think at the Federal Reserve that it is incredibly important as a central issue, how that be done, because we just got through talking about the size of the safety net.

And if we are going to allow taxpayers to end up financing more risky, nonbank activities through insured deposit funds or some sort of too big to pay off policy, I think you have a ticking time bomb on your hands.

So I think it is critical that inexpending expanding powers for banking organizations, the safety net has to be insulated from these expanded powers.

Senator SANFORD. Do you think that the legislation that passed the Senate built adequate firewalls?

Mr. JOHNSON. Do you mean in FIRREA? The recent bill on thrifts?

Senator SANFORD. The banking bill that the Senate passed last year.

Mr. JOHNSON. In many ways, yes, there are good firewall restrictions in there. But I think that there are some gray areas as well.

Senator SANFORD. It certainly was the intention to create firewalls to separate the insured portion of the business from the other portions.

Mr. JOHNSON. There is an issue of how best you do that. And some of the debate has been between whether you can safely do that in direct subsidiaries or through subsidiaries of a holding company, which is a larger legal entity.

Senator SANFORD. I'm sure you understand, that we are now talking about the Proxmire bill.

Mr. JOHNSON. Okay, yes. Well, the Proxmire bill——

Senator SANFORD. That's the only banking restructuring bill that we've passed.

Mr. JOHNSON. Absolutely. We were very satisfied with the structure in that.

Senator SANFORD. Mr. Seidman.

Mr. SEIDMAN. I thought the Proxmire bill was good. We have a few suggestions to improve it, but in general——

Senator SANFORD. We took some of them.

Mr. SEIDMAN. In general, I'd hope the Congress and this committee will address themselves to that in the near future.

Senator SANFORD. We have been looking at how we handle the budget and how we reveal the true deficit, that is, the increase in the national debt. How do we help the public understand that the fiscal year 1990 deficit is some $270 billion not less than $100 billion?

We had a look at what ought to be considered as on-budget or part of a side budget as distinguished from off-budget because, certainly, everything ought to be budgeted and related.

But, should the FDIC be off the operating budget?

Mr. SEIDMAN. I believe they should be. I have testified that like Social Security and other Funds, it really makes no sense to take savings and count it as income. If reported that way to the SEC, you would end up in serious trouble.

And I think that is very misleading in the way that we budget in the Government.

Senator SANFORD. If we had to follow SEC regulations, everybody who touched the budget would have to go jail.

Thank you.

The CHAIRMAN. I want to make two observations before starting a second round here. First of all, we have had 11 Senators participating this morning and I think that is an illustration, with all of the other activities such as reconciliation going on, of how importantly these issues are viewed by the committee.

Second, I want to draw everyone's attention to the fact that we have some very important testimony that is going to be presented after these witnesses leave the table, by Mr. Harry Havens, who is the Assistant Comptroller General of the General Accounting Office.

And I just want to alert everybody to the fact that he has got some important information to present himself.

Having said that, let me now raise this question with the current witnesses. And it has to do with early intervention and whether or not delay in intervention ends up sharply increasing deposit insurance costs down the line.

With the FSLIC and the thrift industry we saw significant losses that stretched out over a period of time. And in your view, Mr. Seidman, in your testimony, is that there is a significant loss rate in the commercial bank failures.

We have had some discussion today on whether early intervention is a good idea and I want to know whether the three agencies, bodies represented here could agree on a common set of criteria as to when we ought to intervene early.

Do we have such different missions and functions here that we are going to continue to view this separately? Or is this a matter of sufficient importance that we ought to have a unified judgment here that lets us know when we come in and why, in order to give us an additional measure of protection.

Who would like to start?

Mr. SEIDMAN. Mr. Chairman, certainly the experience of the FDIC is that early intervention reduces losses.

You cannot eliminate losses, but you can certainly reduce losses by early intervention. I think a standard that would allow that to be done would be very useful.

We have as our basic standard of capital under the old standards institutions that go below 3 percent. If they fall below that level, we find the institution to be in an unsafe and unsound operating mode. And we can begin to withdraw insurance. But that is a long process and has not resulted in early intervention.

And so I think that we could improve in that regard, even though the new act gave us the ability to move much more quickly in that area.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. First of all, I think it is very important that we agree on a common standard in this area on early intervention. But we look favorably on that approach.

And I think that the proposal the Comptroller has put forward is a reasonable proposal in terms of early intervention rules associated with equity and capital insolvency.

I think it is a reasonable approach. We may have our own view, but I think that this is something that we can work out. We should have a common standard.

Mr. CLARKE. Part of the answer, Mr. Chairman, depends on how broadly you construe early intervention. Obviously, one type of intervention is where you close the institution when it becomes insolvent. That can be done only by the primary supervisor. In the case of national banks, we do that. And, as I indicated, we are proposing to change the definition of insolvency. In the case of State-chartered banks, only the State Supervisor can do that. We would hope that those states which don't already follow the equity insolvency concept would embrace that idea as ours is put in place.

But there are all kinds of other interventions, as well. As Chairman Seidman indicated, the removal of deposit insurance by the FDIC, the taking of enforcement actions of various types——

The CHAIRMAN. Let me stop you in the interest of time.

Have the three of you met on this subject?

Mr. CLARKE. Not for the purpose of developing a common standard because the other types of intervention that I am talking about have worked pretty well. For instance, we coordinate with the FDIC——

The CHAIRMAN. Do you think there would be value in a meeting? I don't say that to lead you into one. I'm just asking the question.

Are we at a point and is this a matter of sufficient importance that maybe there ought to be at least an occasion where the three of you sit down together and see if we cannot arrive at some common approach here as to how we're going to make sure that we intervene at the right time?

Mr. CLARKE. It certainly could not hurt. We do that a lot anyway. That is one reason I think the system works pretty well.

The CHAIRMAN. Let me leave that out on the table for you to consider here because I think there are some real questions in terms of the build-up of the stresses that are out there despite everything that we've heard today.

Let me ask just one other question. And I want to yield to my colleagues.

And that is there is a lot of controversy as to exactly how much money is really in the insurance fund these days, and there are people—you referred to and took issue with a study that was done by one of the people at Brookings and so forth with respect to exactly what the numbers are.

I have got great confidence in all of you, as you know, but are we getting the absolutely frankest assessment of exactly how strong the insurance fund is these days?

I want to know where we can really put our feet in terms of how strong it is and how strong it is likely to be six months, 12 months, 18 months from now.

Mr. SEIDMAN. We are giving you, Mr. Chairman, our best judgment and our best information. I think the information given you by your experts has just plain proven to be wrong when examined.

The CHAIRMAN. What is a good figure?

Mr. SEIDMAN. We submitted a detailed study. They have suggested that it was wrong, and then they have changed their minds in some respects. But all of these things are of course predictions of the future. Certainly, the Insurance Fund is not as strong today as it was a year ago because we have lost money. Clearly, we have all said that there are potential problems in the banking system.

But I can assure you, as long as I am around, you will hear about it early on if we see something coming that we think is going to jeopardize the system.

The CHAIRMAN. In terms of the figure, what we have today in the Fund, what is the approximate size of that number?

Mr. SEIDMAN. About $14 billion.

The CHAIRMAN. About $14 billion. And is your best operational estimate that 6 months, 12 months, 18 months from now, will we have a figure of at least that size, or higher? Just your internal operating projections?

Mr. SEIDMAN. Our own projections show that we will about break even this year and that we will begin to increase the Fund next year given what we can forecast in the economy at the present time.

The CHAIRMAN. You are factoring in your concern about weakness in real estate?

Mr. SEIDMAN. We are.

The CHAIRMAN. Leveraged buyouts——

Mr. SEIDMAN. This is factored in by looking at every bank in the country and determining which ones we think we may have to handle over that period.

The CHAIRMAN. Just to summarize what I understand you to be saying: doing a real time update of the banks that you are responsible for and taking into account problems that you see out there, your feeling is that the Deposit Fund ought to hold its own through the next 12 months? That losses will be covered by new receipts coming in? And then beyond a year, as nearly as you can tell today, the net strength ought to start to grow some.

Is that accurate?

Mr. SEIDMAN. That is our best prediction at this time, that's correct.

The CHAIRMAN. Very good. I'm going to go in the order in which people were asking questions. And then go back down through in terms of who has come most recently and who is earliest.

Senator Graham, I think you would be next on that basis.

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to turn to the question of Third World debt in the American banking system. There has been concern as to what the impact of the new risk-based capital standards will have on banks' willingness to loan into third world countries. A basic premise of the Baker plan and, to a lesser degree, the Brady plan was new lending by commercial banks into those areas.

I note in an article from today's American Banker that the report for the second quarter of this year indicates that commercial bank lending to Latin American and the Caribbean slumps to $50.7 billion during that quarter.

Could you give us, starting with Mr. Johnson, your comment as to what effect you believe these new capital standards will have on banks' willingness to loan into the Third World?

Mr. **Johnson**. The risk-based capital standard does not have a country test associated with it. There was discussion about that when it was first being formulated.

But it does not. So there is no risk category for a loan associated with any given country. So the standard in and of itself should not penalize the decision to make a loan to developing countries.

Senator **Graham**. Excuse me. You are providing factual information which was at variance to my previous knowledge.

Are you saying that a loan to, for instance, Brazil, on a bank's asset listing carries the same risk-based value as a loan to Belgium?

Mr. **Johnson**. I am saying basically that for all non-OECD countries, which would include the LDCs, they are in the same risk category as any conventional commercial loan would be.

Now, a sovereign loan to a country within the OECD, I think, does have a lower risk weight associated with it. But we treat non-OECD sovereign loans the same as we would any other conventional loan.

Senator **Graham**. Would most of the third world countries be in the non-OECD category?

Mr. **Johnson**. Yes.

Senator **Graham**. What is the differential between OECD loans and non-OECD loans under the Basle standards?

Mr. **Johnson**. The risk weight for OECD countries is zero percent, whereas, non-OECD countries would be in the 100 percent risk category, which is the same risk category as the standard loan.

Senator **Graham**. So that means that a loan to Brazil on your books is carried at 20 percent, and a loan to Belgium is 100 percent?

Mr. **Johnson**. A sovereign loan—I'm sorry. The other way. The correct answer is OECD would be zero percent; non-OECD, 100.

Senator **Graham**. Let me come back to my question.

Given the fact that our strategy, Baker plan, now the Brady plan, depends in large degree on commercial banks, new lending into those OECD countries, what effect do you anticipate these capital standards will have?

Mr. **Johnson**. Well, I think your point is the effect on loans to non-OECD countries relative to OECD sovereign loans. There is obviously higher risk associated with sovereign loans to non-OECD countries. And certainly that does imply that more capital would have to be carried against those types of loans.

Nevertheless, the multilateral institutions have worked with the LDC countries to work out IMF/World Bank programs that, if conformed to, will supply funds supporting the flow of capital to these LDC's, which, in many cases in the past, has formed the critical mass for which the banks are willing to provide new lending.

In the future, any credits flowing to LDC's will be dependent on the quality of economic adjustments these countries are making and their ability to work out IMF/World Bank programs satisfactory to the banking system.

Senator GRAHAM. Let me ask two questions based on that answer.

One, do you think that there will be a relative shift in new lending into these countries with more emphasis on international financial institutions and relatively less on commercial banks?

Mr. JOHNSON. Well, as you said, there has been some slowdown in the flow and even some reversal of the flow in some cases in the past of capital to LDC's from the commercial banking sector. And to some extent, that has been replaced through multilateral institutions.

But I don't see the multilateral institutions replacing completely the flow of additional funds from the commercial banking system. As a matter of fact, I don't think it is possible.

Senator GRAHAM. The question I asked was a different one. Relatively, do you see over the next 5 years a shift as between the mix of international institutions and commercial banks with a greater degree of third world lending coming from the former? That is, from the international institutions.

Mr. JOHNSON. I think that will depend. That will depend on the quality of economic adjustment that these countries are willing to make, because I do think that commercial banks are willing to put additional credits into those countries, assuming they make significant adjustments that add to investor confidence associated with those economies.

So I think, in many ways, it is dependent on the progress of the economic adjustments as to whether in the future multilateral institutions will represent a larger percentage of the flow of capital to those countries than commercial banks.

I would say unless significant adjustment is made, you are right. Multilaterals will be a larger percentage of the flow.

Senator GRAHAM. I recognize I've gone beyond my time but I am going to persist for one more question.

Since the categories are really an in or out—you are either in the OECD list or you are not in—how does, for instance, a country like Mexico, which appears to be making some major efforts at structural reform.

We see the benefit of that under the Basle standard, standards in contrast to a nation which is more languored in its economic reform effort.

Mr. JOHNSON. Well, I think, if a country like Mexico were to continue to show the kind of progress that they have made in the past, there would certainly be a reassessment of their relative risk compared to the OECD. Like any other developing country, if they prove themselves credit-worthy on an equal basis, I am sure that those assessments will change.

Senator GRAHAM. Is there, to your knowledge, in place a process to review Mexico for that specific purpose?

Mr. JOHNSON. There is a process in place to review all of the LDC credits on a similar basis.

Senator GRAHAM. Thank you.

The CHAIRMAN. To follow up on some other questions about structure and particularly Mr. Clarke's comments when asked about deposit insurance, I recently saw a piece by Mr. Robert Lobbar of the Treasury Department in which he stated that the distinction between commercial banks, thrifts, insurance companies, credit unions and other providers of financial services may become less one of economics than market focus.

There may be more in common among many of these firms all directed toward servicing community retail needs and between others of those firms in their multinational counterparts.

For example, in my State, the First National Bank of Wright City may be more in competition with the local credit union or the sales representatives of Edward D. Johns Security Co. than they have in common with Citicorp or Morgan.

What implications do you see for deposit insurance and structure?

Mr. Clarke.

Mr. CLARKE. First of all, I don't know that it changes anything. I think that you are already seeing that happen where community banks in particular are having all types of financial services firms able to offer banking services as well come into their markets.

That is the reason that all of us believe there should be a greater opportunity for banks, that are the keystone of the financial services industry, to offer those same products. The trick is to figure out how to structure it so that you protect, as Chairman Johnson said, the safety net and provide the benefit of the products but not the risks that may be associated with some of them.

And, it is really not just risk; it is also competitive fairness. If you have some people who have the backing of deposit insurance and others who don't offering the same product, it can be argued, and I think somewhat persuasively, that the one with deposit insurance has the competitive disadvantage. If you required that activity to be conducted in a separately capitalized entity that is regulated the same as one not affiliated with the bank, that has to capitalize itself the same way an unaffiliated entity would, you achieve protection for the safety net. You achieve competitive fairness. And, at the same time, you allow the financial services company to offer the product.

The CHAIRMAN. If you would yield, I'm not sure but you may have misspoken at one point and said that the federally insured institution would be at a disadvantage. And I think that you meant to say "at an advantage."

Mr. CLARKE. I am sorry. I meant advantage.

Senator BOND. There is a way in which there may be disadvantage in certain regulations if they are providing essentially the same services. I think we can look at that answer.

I was trying to figure out the answer from the other way, and I think I can make an argument for it on that side, too.

The CHAIRMAN. I did not mean to quarrel with that.

But I am wrong, you correct me. But, as I understood your answer, I think you meant to say it the other way.

Mr. CLARKE. I meant to say that the insured institution might have an advantage in raising funds over the uninsured institution.

Mr. JOHNSON. I agree with that. The one difference between those two types of entities is the fact that the nonbank financial firm does not have the backing of the federal safety net behind its activities.

It has to raise funds in a private capital market independent of being supported by some government guarantee. And that is the big difference between a nonbank financial activity and one that is in the bank.

So, if the bank is going to be allowed to conduct the same activities to be competitive with its non-bank counterparts, if you allow those activities to be financed out of low-cost insured deposits, then there is going to be an unfair competitive advantage and a potential risk to the taxpayer as well.

So what you have to do is find a way, as Mr. Clarke said, to eliminate the unfair financing advantage that the safety net might pose and the additional risk exposure to the taxpayer from the calculation.

And if you can do that, I think that you want to allow banks to be able to compete and have access to those markets. Otherwise, I think you've got a real problem.

Mr. SEIDMAN. I think the answer is simple. You just let anybody own a bank. So, if there is an advantage to owning a bank, you can own a bank.

If you are an insurance company or an automobile company or whatever you might be, you can own any financial services group that you want.

The key is that if you do own a bank, it is supervised and it has to operate within the banking rules. If right next to it is a securities firm or an insurance firm or whatever, that is perfectly acceptable so that we, if we would get away from this idea that somehow banking is so different that it has to be out there, then we get into all of these problems.

If anybody can own a bank, then the advantage of a bank is available to everybody.

At the same time, when you own a bank, we will not allow it to be used to raise funds for other activities at low rates.

Senator BOND. Mr. Chairman, there was one interesting question that the Ranking Member was going to ask that may be very enlightening to us, and I would like to pose it to the three of you, even though I'm out of time:

The risk-based capital guidelines recently promulgated by the banking agencies from the Basel agreement among the central banks and supervisory agencies of the major economic powers, one of the most important purposes was to reduce competitive inequality arising from differences in capital requirements among nations.

Now, the concern is:

Do any of the other signatories to the Basel agreement require a leveraged constraint in addition to the risk-based capital requirements?

Will the imposition of a 3, 4.5 or 6 percent leverage constraint affect the competitiveness of U.S. financial institutions?

Recently, there was a Wall Street Journal story concerning the competitive advantages of Japanese banks, that the Chairman has called to our attention.

Will the imposition of a leverage constraint in excess of 3 percent disadvantage small and medium-sized institutions that might be competing with branches and agencies of foreign banks doing business in the United States?

Mr. SEIDMAN. I can start by saying that the risk-based standards are not completed yet. They are working on additional standards which they expect to be in place by the end of 1990. Because we are getting into using them earlier than that, we don't know what they are going to be.

But they are going to have additional standards for rate risks which they are working on—in England, the U.K. has already put in additional standards for their banks beyond the risk-based.

So I think all of the countries are going to have to look at the same problem we have looked at, which is that risk-based by itself is a good start, but is not a total banking standard.

Mr. JOHNSON. To my knowledge, other countries who are signatories to the agreement don't have a specific separate standard, although it was agreed that this would be a minimum standard. Other countries could adopt a tougher internal standard, but everyone would have this standard as the same minimum standard for international banks.

If they wanted to adopt a stronger domestic standard for their own banks, they could do so. But, to my knowledge, the risk-based capital standard applies without a subordinate standard except that there may be a few minor exceptions to that.

But I should point out that, in almost every case, the risk-based standard as applied to international banks would require them to have to raise additional capital; for Japanese banks, they had a lot of hidden reserves which could not be counted in the capital calculations and which would require them to raise new equity capital to meet the standard.

So, applying the risk-based standard without any other leverage ratio raises the capital requirements of Japanese international banking institutions just as it would for U.S. money center banks, because U.S. money center banks had large amounts of off-balance sheet activities. These are now included on the balance sheet and given credit exposure and risk weight.

And that means that they have had to increase their capital. Plus, it is a tougher equity standard. So, money center banks have had to increase their equity capital.

So I don't think it represents a reduced competitive position for U.S. banks at all because other banks were affected negatively in terms of the amount of capital that they had to raise.

Mr. CLARKE. Your question about whether any of the other signatories to the Basel agreement have adopted a leverage ratio, I cannot answer with respect to every country. But, in the UK, for instance, the Bank of England, which is the Supervisor of the UK banks, does not have a leverage ratio of any kind. They have asked me several times why we have one. The answer is that we believe there are other kinds of risks associated with the operation of a bank that should have some capital behind them. But as Chairman Johnson has indicated, the Basel agreement does not require one, and many countries are operating without one.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. If you would indulge me for one minute, Senator Bryan.

Senator BRYAN. Sure.

The CHAIRMAN. You have raised I think very interestingly before Senator Bond the additional powers issue, and you got into an illustration there. I want to just pose a hypothetical. I don't want to get off into that discussion or we will be here the rest of the day.

But on the issue of insurance being sold by banks, many of the non-money center banks that I hear from in Michigan think that the most attractive additional power that they see out there is the power to get into the insurance business.

And one can understand the argument that they make. You have addressed the issue just in passing on the question of, if you put it in a separate affiliate so that you break off the advantages of lower-cost financing because the deposit insurance, that is one way to bundle any other new powers or new lines of business, and separate it off from the basic financial advantage of the bank itself, and that would be a way to address this one question of a differential cost of capital where you are creating competitive inequity against private insurance companies or whatever.

The second argument that is normally raised is the tie-in arrangement. In other words, the banking function is quite special because it is the principal credit source for people. And if somebody's coming in to get a home mortgage, a car loan, to get a line of credit, and so forth, is there a real or implied pressure to take unrelated services that the bank, albeit even in a holding company, might be offering, whether it be insurance or real estate brokerage services or whatever else.

And the tie-in question has always been one of the most difficult ones to try to resolve. And the extent to which it might be real or apparent, we have had one banker who was very innovative in terms of broadening out the lines of business, who appeared before this committee, who really had set up one-stop shopping in the banking institution itself, and it is sort of like services in the round structure.

And you walk in and you can go to the teller window and you can do your basic banking services, and then you can go to a booth that, as I understand it, sells insurance or products like that, where they are allowed to do that, or a travel service, a real estate service or whatever else.

So you can walk in and it is sort of a one-stop shopping concept. As I hear that argument made on the one side and then hear from the insurance people who say, "You know, if there is a competitive business in this country that has got plenty of people in the game and no barrier to access, it is people in the retail insurance business."

So they sort of say:

Well, you know, if we had a monopolistic problem out there, maybe you would want to bring in new players sort of mandate new players into the game.

But, as it is the retail insurance business is working off very tight margins, or so it appears. We did not regulate that business at the Federal level, so we're not perhaps as knowledgeable about all of the ins and outs of that business.

But they then say, in return, if you are going to do that and is there the potential for the tie-in problem, if you're going to bring these guys into the business and make them operate down the stream with a different name and really have some firewalls in terms of tie-in problems. Do you have any answers in that area?

Do you have any concerns in that area? You have addressed in a sense the financial aspect questions by talking about—at least the two of you did—quite clearly about the separate affiliate.

But, how about the second issue that arises?

Do you have any thoughts on that?

Mr. CLARKE. The tie-in part, you mean?

The CHAIRMAN. Yes.

Mr. CLARKE. First of all, banks already offer a lot of insurance products, as you point out, in States where it is permitted. Even national banks are able to sell credit life and accident and health insurance, title insurance, and things of that sort.

An insurance agency is not a very capital-intensive business, so you have to raise the question of whether there really is a competitive advantage in a bank engaging in that activity. You have to also wonder whether there is really any safety and soundness problem in acting as an agent in the sale of insurance. You don't really see very many massive losses being taken by insurance agents.

Underwriting is a little bit different animal; there is a lot of risk associated with that, and there's a lot of capital required. It seems to me that if you were to permit insurance underwriting by banks, that should be put in some type of an affiliate.

The tie-in question is something that banks are faced with every day with their current product lines. As you know, banks today can say they will make you a car loan if you will also buy a safety deposit box from them and use the Master Card that they issue. Those kinds of requirements are illegal. If banks were allowed to offer more insurance products, we would have to guard against tie-ins and try to stop them, the same way we do today.

The CHAIRMAN. Any other brief comment?

Mr. JOHNSON. The tie-in is illegal and so it would be simply illegal to try to force the purchase of a whole array of services.

And I agree with the Comptroller that the agency activities, such as the insurance agencies activities, the brokerage of insurance, does not represent a safety and soundness issue. In many cases, that is why you find them in banks themselves.

It does though potentially I think raise a competitiveness/fairness issue because, even though they are not capital-intensive activities, it is still potentially possible for insured deposit financing to subsidize the brokerage commissions on real estate agency services.

And it could add to the downward pressure on margins being subsidized through taxpayer funds. And so I think that, actually, as a matter of competitive fairness, there should be some consideration of possibly separating it from the bank itself for that reason.

It doesn't raise a safety and soundness question. Some of the underwriting functions do. But, as to the tie-in issue, I think that a certain amount of marketing synergy should be allowed. I see nothing wrong with brochures that advertise an array of services that can be made available through various affiliates and subsidiaries of banking organizations.

But, the tie-in is strictly illegal.

The **Chairman**. I am not sure that it requires a further comment, although I don't want to shut you off.

Mr. **Seidman**. I would simply say that, when you see new competition coming down the road, you grab for any argument you can. I guess the insurers would like to keep the banks out of the business. Tie-in has been controlled for a long time.

The **Chairman**. Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman. I would like to pick up on a line of questioning that Senator Bond concluded with. And that is the article that appeared a couple of weeks ago in the Wall Street Journal, the thesis of which is that U.S. banks are losing business to the Japanese both at home and abroad.

I have a couple of two-part questions.

If you agree with the thesis of the article, should we be concerned. And if so, what ought we be doing about it to rectify the situation? Mr. Seidman, we can begin with you since you got off easy in the last question.

Mr. **Seidman**. I think the Japanese banks are increasing their market share, and they are doing it by providing competitive services. I don't think that we need to be concerned unless they gain such a share that it raises real concerns with respect to their ability to control our system.

I think it does raise the question of our providing a structure which will allow us best to compete with them. I don't think we have that structure in the country now.

Senator **Bryan**. Mr. Seidman, let me just respond if I may and then give you a chance to follow up.

You say you don't think we should be concerned. I guess, for a number of us who have responsibilities in other Committees there is an apprehension that this may be the beginning of a trend. As recently as 1970, as we were told the other day in the Commerce Committee, American manufacturers had 90 percent of the color television business in this country. Today, we have less than 10 percent.

In that same year, we had basically 100 percent of the machine tool business; today, it is down to about 35–40 percent. And you can go on and on and on.

Now, I don't know that there is a categorical analogy to what we are talking about in banking, but it is the trend that appears in terms of America's competitive position with the Japanese in a host of fields that is a concern to a number of us.

And I guess my question—you say there is not a cause for concern. If I can get a follow-up, what do you think we need to do in the Congress, if anything, to address the competitive disadvantage? You say we don't have the structure. I'm not quite sure what you mean by that, sir.

Mr. **Seidman**. I put an answer on a broader structure than banking. I think that the question of our competitiveness in the world goes fundamentally to the kind of economic system we have, the kind of savings that we encourage. I have a new book coming out in the spring called The American Advantage, which deals with that. I will be sure that you——

Senator **Bryan**. Maybe we can get a galley proof early.

Mr. SEIDMAN. The basic approach is that we need to go back to some of the American fundamentals and structure our system so that we again are savers and competitors. However, we will never be dominant the way we were before because our domination came from being a victor in World War II without having damaged our economy.

I think the days when we did 100 percent of anything, those days are not going to be returned to.

The question is how we can run this country so that our businesses, our warriors, if you will, are out there in the world competition.

Senator BRYAN. I don't disagree with any part of that.

Mr. Johnson, I might ask you specifically if there is a reason that we ought to be concerned in terms of our economic system. What ought we to do about it?

I agree as an aside that the situation after World War II was somewhat of an aberration, not likely to repeat itself in the course of history. So that is not the benchmark that I would use as a point from which a concern ought to be addressed.

But, certainly, 1970, to use the analogy that I just did with respect to machine tools and color television and semiconductors, and we can go on and on, by 1970, we were well-passed. You know, the destruction, the aftermath of World War II in 1945.

What ought we to do, if anything?

Mr. JOHNSON. First, I think that the one thing we shouldn't do is become more protectionist over this concern. I think that we should worry about our international competitiveness and concentrate on the ability of U.S. firms to compete.

But there are major economic advantages to the industrial world and even the developing world to have open, free trade and the free flow of financial capital. And that is a great benefit that should be fostered and nurtured.

But, at the same time, I think that we should worry about our domestic cost of capital because I think that it does make us relatively less competitive internationally.

And I think that some of that is due to the effects of the federal tax system on business depreciation and investment activity.

A lot of it has to do with our low savings rate, and we need a higher savings rate in the United States in our domestic economy. And we need to take into consideration how our tax system affects that and how we can actually induce a long-run view of the necessity for savings in this country rather than short-term consumer-oriented society.

And I think that some of that has to do with the tax system, and some of it has to do with the fact that, although it has been well-intentioned, we have created a lot of saving substitutes in our society. Income maintenance programs are great, but they do substitute for private savings.

And the fact is that the lower savings rate we have has raised the cost of capital and hurt our international competitive position.

Senator BRYAN. Would that be in your judgment the principal concern or problem? Are there other structural changes? I kind of sense the tone of the responses is that we really ought to be greatly concerned about this. And our low savings rate—I think most of us on the committee would agree with that.

Any other structural changes, if you were writing a blueprint for the Congress to follow? Anything other than policies addressing this change in the savings rate, to enhance and to reward that, rather than to encourage consumer spending?

Mr. JOHNSON. I honestly think that that is the most important thing. But I do think that there ought to be coordination and cooperation among the major industrial countries in trying to maintain the conditions for free trade and avoid unfair government subsidization of production in terms of trade. And the GATT has done a good job with that.

And I think we need to continue on with these international fora on fair trade. And even intensify those efforts.

Senator BRYAN. Mr. Johnson, there seems to be a disagreement in terms of capital standards between the OCC and the FDIC.

Where do you come down on that issue?

Mr. JOHNSON. First of all——

The CHAIRMAN. At the table, he's right in the middle, as you can see.

Mr. JOHNSON. That is the problem.

The CHAIRMAN. That may be the answer, too. [Laughter.]

Mr. JOHNSON. I was hoping to avoid that.

The fact is that the Board has not made a final decision on where it stands on this issue. And as the Chairman suggested, we see pros and cons to this issue.

The fact is that both sides, the Comptroller and the FDIC, agree on the equity capital requirement of 3 percent.

The only difference is whether to have an additional amount of what we call tier two capital over and above equity associated with the minimum leverage ratio.

And I think there are several issues in determining whether that is something necessary.

Most of the banks who would be caught in the net in the difference between 3 and 6 percent minimum leverage ratio are problem institutions, which we—or any of the bank regulators—would require to hold more capital than the minimum already.

And so, in fact, the net of an additional 3 percent would only generally capture what are already mostly problem institutions and already have requirements to hold more capital than the minimum standard that exists.

So I think that is an issue that has to be looked at closely as to what additional capital adequacy you are getting when, in fact, these institutions already are having to hold more capital.

I want to point out that there is no substitute minimum capital requirement, differences aside, for discretionary examinations of institutions.

And I need to emphasize the minimum leverage ratio simply represents the minimum requirement for a well-behaved institution that doesn't have concentrated lending, that has exceptional loan qualities, and that has not concentrated its activities in any one particular risky area.

And there is no substitute really for a hands-on case by case examination of banks. And when we do that, we generally require additional capital above the minimum because banks do have more concentration in their asset portfolios than is desirable. They do end up having off balance sheet items or other types of activities—interest rate risk in their portfolio, which is not captured by the risk-based capital standard.

So, capital requirements are often, as a matter of fact, higher than the minimum ratio because most banks deviate from the ideal institution. These issues have to be taken into account, and that is why I think we haven't made a final decision on where we stand on this issue.

Senator **Bryan**. Do you expect to address that issue and take a stand?

Mr. **Johnson**. Yes, we're going to have to resolve it because we do think that there should be a common standard, if at all possible.

Senator **Bryan**. Mr. Chairman, thank you for indulging me, and my apologies to Senator Bond.

I exceeded my time, but we have not heard from Mr. Clarke, if that would be possible.

The **Chairman**. It is very important that when we have a line of inquiry going that we are able to try to complete it.

I'm going to just raise one other thing and then I'm going to try to ask that we submit the rest of our questions, if we can, for the record, because I think we need to hear the GAO.

If there is a burning issue, then——

Senator **Bond**. I have one question.

The **Chairman**. All right. Let me call on you in one second.

We had a witness here on October 5 who made a very important observation with respect to this growing competition, particularly from Japanese banks in this country, which to me is a matter of concern in terms of how it works and the equities in the long-term health and well-being of this country.

And we're going to spend a lot of time looking at the competitive, international competitive relationships in this Committee because they have to do with what our balance sheet looks like, and increasingly will look like as a nation.

But, Dr. Kaufmann, who was here, said this. He said that:

"The Japanese banks are enormously helped because of the vast savings pool in that country."

They have much higher savings rates and, therefore, they have got lower cost capital available to them off of the difference in national impulse there versus here.

They obviously also are doing quite well because of the huge trade surpluses that—we are trading our money for their goods and they are adding off with an additional part to their capital pool, which is money that, yesterday, was ours and is, today, theirs.

And it comes back in here to be loaned out under different terms and conditions.

He makes the point that if Japanese banks then armed with this greater financial strength and resource are going to come in here and compete head-on in our financial system, that our banks, in turn, have to have access to their savings pool in Japan.

In other words, all other things being equal, if we're going to have national treatment here, we've got to have national treatment there. National treatment just isn't on the side of offering goods and services, it is on the side of competing for the savings pool, which, in turn, becomes the operating wherewithal of the banks, whether they are Japanese banks or U.S. banks.

And I thought that was a very compelling argument and put in a fresher way than I have heard before. And that is that you cannot uncouple the system. If you are going to have a global system that works all the way around, it cannot decouple at some point to the advantage of an international competitor and to the disadvantage of an American person or entity in the same business.

So, my clear sense is that American banks are not getting national treatment today in Japan, are they?

Mr. CLARKE. Well, I will attempt to answer that, Mr. Chairman.

The CHAIRMAN. I would like a yes or no. Either we are getting national treatment or we're not. I know that there is an elaboration, but the fundamental answer either is essentially that we are or essentially we are not.

I guess I would like to start there.

Mr. CLARKE. If National treatment is measured by U.S. banks having a major presence in Japan by being able to own Japanese bank, the answer is no. U.S. banks do not own Japanese banks to any significant extent. There are very few Japanese banks to own, it should also be pointed out. U.S. access to the savings base that you are talking about is not as easily effected as it is in other places, such as in the European Economic Community.

Senator BRYAN. If the gentleman would yield, is that a matter of practice or law, or what prevents that access I guess is the follow-up question?

Excuse me, Mr. Chairman.

The CHAIRMAN. No. I think it is a good question, Mr. Clarke.

Mr. CLARKE. It is due in part to the fact that there are very few institutions and that not that many become available for acquisition. Some suggest that there are regulatory impediments, silent and unstated. I cannot comment about that.

The CHAIRMAN. Shouldn't you know that? Isn't it not really a part of your job responsibility and ours, if that is the case, to put somebody to work on it so that we do know?

Mr. CLARKE. We have people who have been on it for a long time. And the answer always is, of course, "No." There are no impediments, but there just aren't any transactions that take place.

The CHAIRMAN. Well——

Mr. CLARKE. Of course, it is also possible to access the savings base you are talking about through startup institutions. It is more difficult. It is very difficult to compete against a large Japanese bank by starting a newly organized bank. That also is not being done, and I cannot tell you for what reason. But there is very, very limited ability for U.S. banks to participate on that basis.

The CHAIRMAN. Let me say this to you. If you extend the trend lines, if nothing alters this situation, and the capital accumulation continues on their side, and their banks have access to our system where they are coming in with greater and greater strength, it doesn't take a genius to see where that eventually leads.

It seems to me that, eventually, it leads to the fact that we are going to be so diminished, we will never break into their market for whatever the reasons, and they will become an ever more dominating factor in our market.

You know, I don't understand what other scenario there is down the track than that one, barring some catastrophic change in the situation.

And it seems to me that we are on a track, a competitive banking track international here, that we better get off, or that we had better find a way to adjust.

I must say I have to expect to look for some guidance on that from you folks.

And we should try to provide some as well and that is why we intend to get more deeply into this subject.

I think there is an affirmative obligation on the part of our basic banking system leaders, if you will, in the public sector, as you all are, to try to get a fix on this and give us some sense as to where this is taking us and whether this is healthy and sound in the long-term.

We have had people come in here ranging from John Reid at Citicorp to a lot of others who were genuine heavy hitters, who said that they are concerned that more and more, we are ceding a larger and larger part of the financial future of the country and financial decision-making to foreign decision-makers, partly because we are hooked on the foreign debt.

But, very importantly, too, there is a question of the very rapid transition in how the financial structure itself is owned and run.

While we are doing all of the micro-things, we had better be looking at sort of the broad, global macro things and deciding whether these trend lines are healthy for us.

I don't sense that they are.

Do you have a thought on this, Mr. Johnson? I know we could have a whole separate morning on this subject. In due course, we will.

Mr. JOHNSON. Like Mr. Clarke, I mean, we don't find any rules that establish impediments. In fact, the evidence is that national treatment does exist.

But, the fact is transactions don't occur. However, we are unable to find any clear impediments to setting up separate banking affiliates in Japan. Right now, U.S. institutions have mostly branched over there. They have branch organizations that offer services in Japan, but not separate affiliates.

Now, why they have made the decisions to do it that way, I don't know because the banking supervisors in Japan say that there is absolutely no regulatory impediment to U.S. banks applying for separate, stand-alone subsidiaries of banking organizations, in the Japanese market.

Now, I agree though the access is not what we ultimately would hope for, but there is no evidence that our institutions are not getting national treatment.

What we have done to prevent unfair advantage from foreign institutions in accessing the U.S. market is that we have worked hard for a long time to negotiate this international capital standard, the risk-based capital standard. And, in fact, what was going on before then was that Japanese institutions and other foreign institutions were able to come into this country, establish subsidiary operations, or even buy into the U.S. markets with a lower capital standard than our own domestic banks had to have.

And so they had a lower cost of capital internationally and in the domestic market than existed before this international risk-based capital arrangement was negotiated.

So, one of the things we have done is that we tried to achieve—United States initiated this whole process, by the way, and the Basle Agreement does maintain—equivalent capital standards across international banking organizations.

And I think that is a major milestone in avoiding foreign institutions coming into the U.S. with capital cost advantage to U.S. firms.

Now, that doesn't solve all of the problems by any means because there are still different ways of doing things.

And I think one of the greatest threats that I worry about the most is that, even though we have these capital standards, we all have different types of safety nets in place. And I still worry that central bank or government banking supervisors in foreign countries are going to somehow subsidize the cost of capital to foreign banking institutions and make it easier for them to raise capital relative to U.S. institutions.

We have a very large safety net here. And in my opinion, larger than needs to be. But, because of that, we have to protect the exposure that taxpayers have to risk in the banking system, and because of that, we have a tougher regulatory structure than many other countries. The banking structure in Europe is basically a universal bank where a bank can get into almost anything directly in the bank itself.

They argue that is the case because they don't have deposit insurance in those countries. They have insured deposits, but they are coinsurance schemes in the private sector. They are not federally insured deposit programs there.

So they do not feel the need to protect their system the same way we do. However, they have had managed supervision in the past and they have been small countries with very few banks in Europe. And so the safety net has been somewhat off the record, so to speak, or nonstatutory. But my concern is that, over time, foreign safety nets will become more aggressive and subsidize the capital cost of international institutions relative to the U.S.

And we are going to be at a disadvantage if—but the worst of all possible things would be to get into that subsidization war because then I think it exposes U.S. taxpayers to extreme risk.

The CHAIRMAN. This is a profound issue that is put on the table. It comes very late in the hearing today and, in a sense, it wasn't the center of our target for today.

But I do want to say before yielding to Senator Bond that we are going to ask you to come back in, in an orderly time frame, precisely on this question of how we now take our internal system with all of the characteristics and tugging and hauling that is going on, and look at it in the framework of this dramatically changed and changing global economic system related to Europe 1992, related to this problem as it relates particularly to Japan and some others as well, with the thought of trying to better understand the applications of these big trend lines that we are writing into the future.

And how do we avoid, for example, situations in the future where we adjust down to a lower common denominator because of the rest of the world having a different safety net concept, and various other things.

Can we just per force willingly accept an adjustment to a set of standards that, in the past, we have thought were appropriate to our system.

Do we really want to do that?

What are the implications? And how do you stay competitive?

These are issues that we really need to get up on the table so that we're not just dealing with yesterday's problems, but we are dealing with the ones that are really coming at us.

Senator Bond.

Senator **Bond**. Mr. Chairman, I only wish that the rest of our committee members could have heard your question and the exchange because I think you have raised some very challenging issues that we are going to have to deal with.

First, I have one suggestion and that is, when you raised the very legitimate point that it did not appear that there was U.S. ownership of Japanese banks and that you suggested we put someone to work on that, I respectfully suggest that we have probably not yet invented a bank regulator or a trade negotiator with sufficient longevity to last out the negotiations to see the United States buying a Japanese bank.

That gratuitous comment aside, the statement that Governor Johnson made and a statement that Mr. Clarke made earlier about the size of the risk on deposit insurance. I would ask if you think from our discussions today that we should be considering a separate bank charter; or two separate banking entities.

One would be the traditional retail bank in Wright City, Missouri or in a Borough in New York handling retail business, attracting the deposits which absolutely have to have the safety net, limited, restricted, as our banks traditionally have been in their activity; and on the other hand, a much broader banking charter, the international banks that can take different kinds of risks, still subject to supervision but for those which have been agreed, I believe, represent a disproportionate risk to the FDIC safety net, we say:

Go out, get your wholesale deposits, do what you want, but we are not going to put the safety net at risk from a great big boulder like you falling through it.

Should we be looking at bifurcation that would eliminate deposit insurance for the wholesale money center international banks?

Mr. **Clarke**. My short answer, Senator, would be no. While I think it is appealing and, of course, has been suggested by a number of people, it doesn't completely solve the problem that you are trying to solve. And, it may make the system even more fragmented than it already is. I think the way to deal with the problem is to try to figure out how you craft a structure of supervision and capital standards that allows everybody to be in whatever market niche they want while protecting not just the insurance fund but the entire federal safety net. I would avoid the two separate banks, the so-called narrow bank approach.

Mr. **Johnson**. I personally think that the model ought to be looked at carefully. I think that there are some possibilities of having a very strict type of bank as an option where the safety net can be insulated.

But I think, if it is going to work, you still have to solve the too big to fail problem, which, as Chairman Seidman pointed out, is as big if not a bigger issue than deposit insurance and the access to the discount window in the payment system that is provided through the Federal Reserve.

Those are issues that have to be addressed as well as deposit insurance. But I think that approach has some potential if it is done with those ideas in mind.

The CHAIRMAN. Would you yield at that point?

I'm wondering. I think that is such a powerful question you pose. I wonder if we should be initiating such a study as you just described. In other words, what I hear you saying is:

It is fine to take a look at deposit insurance.

Senator BOND. It ought to be bigger. We should not focus just on deposit insurance is my initial reaction. I would agree with the Chairman.

The CHAIRMAN. The point you just made about too big to fail being one of the issues that we look at in this whole question of international sort of change in kind, to sort of be able to operate on international playing fields.

I think we should give some thought here as to what perhaps ought to be looked at.

Would you folks as a rule self-initiate a sort of big look at something like that?

I know you've got a lot of things to do anyway just on the day in and day out activities. Would something like that be better focused if there were requests that were, say, to come from this committee, that has posed the question?

Mr. JOHNSON. We are trying to include that in our overall assessment on deposit insurance reform. We are looking into it but we would be happy to come and discuss it when we are ready.

Mr. SEIDMAN. The too-big-to-fail issue is specifically a part of the Treasury study because it indicates that we should study the question of whether we should ever support any deposit except an insured deposit.

So that is the too-big-to-fail doctrine. It is one of those things that is much broader than the deposit insurance, really.

The CHAIRMAN. Senator Bond yielded.

Did you want to add one other thing?

Mr. CLARKE. You all have already commissioned a study. I think that that will be embraced in the whole concept of deposit insurance.

The CHAIRMAN. I think we have to take a look at that, as to whether or not the suggestion has been broadly enough phrased and structured so that we are really getting, you know, to these big, international impact questions sufficiently.

That is the world that we are in now—we have been, you know, catapulted into. We are into a whole new—it is so difficult to understand. I think there are too many things going all at once. To have to go to an international assimilation way of looking at things and dealing with things is a whole new task for us. Very difficult to do, whether you are on that side of the table, this side of the table, or positioned some other place.

Gentlemen, thank you very much for your testimony today. We will have additional questions I think from some members for the record, and we appreciate your comments to us.

Let me now call to the table our GAO witness, the Assistant Comptroller General, Harry Havens, and thank him for his patience in waiting so long here.

Let me invite everybody remaining to find a seat, if they can. I am sure that you found that discussion this morning interesting, Mr. Havens, bringing as you do an independent vantage point on this whole thing.

We've got your full statement. I know the hour is late. I think you've got some important things to say here and they need to be part of the record.

STATEMENT OF HARRY S. HAVENS, ASSISTANT COMPTROLLER GENERAL OF THE UNITED STATES GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY CRAIG A. SIMMONS AND LAWRENCE D. CLUFF

Mr. HAVENS. I understand. I would ask that the statement in its entirety be entered in the record.

The CHAIRMAN. So ordered.

Mr. HAVENS. I have a couple of points that I would like to emphasize, Mr. Chairman. Our bottom line conclusion is that now is not the time to start reducing minimum capital requirements.

The CHAIRMAN. Let me—pull the mike nice and close. It is late in the morning. A lot of the press folks are gone, but it is very important, what you just said, that it be heard clearly throughout the room.

Do you want to say it again?

Mr. HAVENS. Our bottom line conclusion is that now is not the time to start reducing minimum capital requirements.

We are very strongly in favor of the risk-based capital standards. We think that they are an enormous improvement. We think they will be very useful in the long-run. But they are not yet in place. We don't yet know how they will work. We don't yet know how the regulators will regulate with respect to them.

And until some of those questions are answered, we believe it would be premature to reduce minimum capital requirements. That is sort of where we are.

And I don't think much more than that needs to be said in terms of an opening set of remarks, Mr. Chairman.

[The complete prepared statement of Harry S. Havens follows:]

United States General Accounting Office

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Testimony

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Minimum Capital Requirements for Banks Under Risk-Based Capital Standards

Statement of
Harry S. Havens, Assistant Comptroller General
U.S. General Accounting Office

Before the Committee on Banking, Housing and
Urban Affairs
United States Senate

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss our views on minimum capital requirements for the banking industry.

During the first quarter of 1989, the three federal bank regulatory agencies (the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC)) adopted final risk-based capital standards. These standards specify the amount of capital, classified as Tier 1 and Tier 2, that banks must hold as of December 31, 1992. However, banks holding low-risk or riskless assets, as defined under the risk-based capital definitions, could meet the 8 percent requirement but still have a very low capital-to-total-assets ratio. The agencies agree that a minimum capital-to-total-assets ratio or "leverage constraint", should be established to work in conjunction with the risk-based capital standard. However, they disagree about how high this floor should be set.

On September 8, 1989, the Comptroller of the Currency proposed that the risk-based capital guidelines be supplemented with a 3 percent Tier 1 capital-to-total-assets floor.

The FDIC opposes the OCC proposal. FDIC maintains that risk-based capital, even with the proposed capital floor, may increase the risk of loss to the deposit insurance fund by effectively allowing some banks to reduce capital from the levels required under the current standard. The FDIC has indicated that it would prefer to set the capital floor higher than 3 percent by adding some level of supplementary (Tier 2) capital to the 3 percent Tier 1 capital floor proposed by the Comptroller.

In describing the effects of risk-based capital standards, the three regulators indicate that in most cases banks with greater than $1 billion in assets will find it necessary to increase capital to meet the risk-based capital requirements. These banks would be generally unaffected by the OCC proposed requirement for at least a 3 percent capital-to-total-assets ratio. This results primarily from the considerable off-balance sheet assets held by the larger, multinational institutions. On the other hand, smaller banks would generally not have to raise capital to meet the risk-based capital standard. These banks, could, in the aggregate, reduce capital and meet the standard. The FDIC believes that this would still be true even after imposing a 3 percent minimum capital-to-total assets ratio.

The OCC believes that one important reason for implementing risk-based capital standards is to reward less risky banks with lower capital requirements. The FDIC, on the other hand, believes that banking is increasingly risky today and, therefore, minimum capital standards should not be reduced for any bank. In their opinion, risk-based capital standards were designed primarily to force risky banks, especially large international banks, to raise capital.

Attempts have been made to prove the validity of one position or another by demonstrating how many banks would be affected under different capital standards or combinations of standards. The numbers show relatively little difference in the number of banks affected by modest variations in the capital floor to accompany the risk-based standards. These analyses do not, in our view, fully resolve the issue. Banks do not currently report sufficiently detailed information to calculate their risk-based capital positions accurately. Moreover, banks are likely to adjust their asset portfolios in response to the incentives built into the risk-based standards. Thus, any snapshot taken today is unlikely to remain valid in the future.

After reviewing the issues, we conclude that capital requirements should not be lowered for any banks in the process of converting to the risk-based capital standards. This view reflects the following considerations:

-- Bank regulators have not demonstrated that they have sufficient expertise and resources to exercise adequate oversight and supervision in a world of risk-based capital standards.

-- Banks are conducting business in an increasingly competitive environment.

-- In the aftermath of the thrift disaster, neither the public nor the banks should be given a signal by the regulators that lower capital levels are acceptable.

-- The risk-based capital standards do not address some significant risks, i.e. interest risk faced by banking institutions. Because credit risk will now have a higher cost (because of the increased capital requirement), banks may well change the composition of their asset portfolios to include more interest-rate sensitive assets in the future. This may actually increase the exposure of the deposit insurance fund to losses unless banks have sufficient capital.

-- FDIC's insurance reserves are at historically low levels.

Once risk-based capital standards have been fully implemented, and we have experience with the banking industry's adjustment to the standards, the minimum capital requirement can be reassessed and adjusted, if appropriate. However, in our view, there should be no reduction until:

-- The bank regulators have sufficient resources and have demonstrated the ability to oversee and enforce the relatively more complicated risk-based capital standards.

- -- The FDIC's insurance reserves have increased to the minimum levels suggested in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Other issues that should be considered when reassessing the minimum capital requirement include:

- -- whether adequate provisions can be developed to include other appropriate risks, such as those arising from interest rate fluctuations, in the standards, and

- -- whether a means can be found to eliminate or reduce some of the other incentives for unsound practice found in our deposit insurance system.

In the final analysis, adequate capitalization is the first line of defense of any financial institution. Any proposal that could yield a reduction in that capitalization should be viewed with great caution.

That concludes my prepared statement. My colleagues and I will be happy to answer questions.

The Chairman. Well, I asked for a summary and you gave me one. [Laughter.]

Let me run through a couple of questions with you here. The witnesses at our first hearing testified that bank capital levels are lower than they were before deposit insurance was introduced, and lower than levels maintained during the more what we might call tranquil economic environment in the early 1960's.

I am wondering if GAO has an opinion as to what levels of capital we ought to establish or employ here to have U.S. banks maintain.

Mr. Havens. We don't have a particular number that we hold in mind. By and large, we think they need more rather than less. We think there is clearly a problem in the big banks that is beginning to be addressed by the risk-based capital requirements. The primary effect of those requirements is going to be on the big banks, the money center banks, which have the off balance sheet risks attached to them and which will have to raise substantial additional capital to meet the new standards.

But we also worry about the smaller banks. They don't pose the same dollar amount of risk to the FDIC as do the big money center banks but, at the same time, as a problem they are disproportionate in terms of numbers.

And, therefore, we think that you need to be concerned about some of the banks that would not be affected by the risk-based standards that would be affected by a higher tandem standard than proposed by OCC.

So we think you would need to worry at both ends of the spectrum.

The Chairman. You have heard before today and then again today the positions of the FDIC and the OCC on this issue of what the standard should be.

Are you able to support one position rather than the other here?

Mr. Havens. I would not say that we support one position rather than the other. Perhaps because of where we stand when we look at issues, we tend to be conservative in our view of what ought to be required.

Therefore, we find ourselves frequently in agreement with FDIC and Chairman Seidman, who, also being the Insurer, tends to be conservative in his views.

We would lean more toward FDIC's view of the situation and desired outcome than the other. But, at the same time, I have to say that we believe in risk-based capital standards. So it is not a matter of we think those standards are wrong or anything like that.

It is that we think they need to be supplemented and we suggest that they be supplemented by more than OCC proposes.

The Chairman. Now, as I am sure you may know, on the October 5th hearing that we had here, we heard testimony from some asserting that the reserves of the FDIC bank insurance fund—our interview of the witnesses—we had lower than is actually being reported.

What is GAO's view on that matter?

Mr. Havens. I am aware of the study. Our sense was that it was flawed in some important respects with respect to the data. We haven't tried to replicate it so I don't know where we would come out in that regard.

I would point out, however, that GAO does audit the financial statements of the FDIC. Our last financial statement audit was issued about 6 or 7 months ago, and we have rendered a clean opinion. That is, we found that the financial statements accurately reflected the financial condition of FDIC.

And I have no reason to think that that would be different today.

The CHAIRMAN. Are you in the position presently to assess the discussion we had earlier that indicates that the FDIC will probably break even for the coming year, receipts versus payouts? And, therefore, that its capital balance will not be eroded further?

Are you in a position to make an independent judgment on that kind of a forward assessment based on looking at trend line data and such?

Mr. HAVENS. At this point, we don't have any unique information that would cause us to question it.

The CHAIRMAN. Would you normally have that just as a matter of understanding the process that you have gone through and normally go through?

Would it be reasonable to expect that if that was off the mark, you would not, or not?

Mr. HAVENS. I think it would be reasonable to think that we would not.

Mr. SIMMONS. I would certainly agree with that statement. Their cash flow, especially the near-term cash flows, will be taken into account as part of the financial audit.

The financial audit should be out, I suspect, in the early to midspring of next year.

The CHAIRMAN. But, I take it that this is monitored on a real time basis?

In other words, you feel quite up to date on where they are now and what their sort of trend line performance is looking like as it comes in month by month.

Mr. SIMMONS. I believe we are in touch with the FDIC and get their monthly reports, and take a look at them. So that, when you do the financial audit, you have a great deal of information already available and you don't need to start from scratch every year.

The CHAIRMAN. I don't want to put words in your mouth, but I don't want to draw a conclusion that is incorrect in my mind either.

So I would prefer to state it and then have you tell me if you feel this is a fair summary.

I take it from what you were saying that you feel that the FDIC posted reserves at present are accurate. You don't see any extraordinary erosion going on or on the immediate horizon.

And so you are not expressing to this committee a great concern about whether or not that Fund is in some kind of near-term jeopardy?

Mr. HAVENS. I think that is a fair characterization of what I have said today. Now, I do have to qualify it to the extent that things always go wrong somewhere in the system, you know, from one time to another. And you cannot always know what those are going to be ahead of time.

The regulators have expressed their view that they are dealing with the LBO situation. And from where we stand, that seems to be correct.

The money center banks are reserving more adequately against the LDC debt than they were. That seems to be moving in the right direction.

I am not sure I would go as far as the regulators did earlier to say that that problem is behind us. I am not convinced that it is yet.

But it's going in the right direction. But I don't know what the next problem is going to be. I don't know if it's going to be oil patch again or the ag economy again, or Northeast real estate market, you know, being the next problem. I really don't know where the next problem is coming from.

I just know that somewhere out there, there is a problem that we have not yet taken care of.

The CHAIRMAN. We just took a $10 billion hit off of two natural disasters at a minimum—Hugo on one coast and the earthquake on another. And, all of a sudden, you know, we have a $10 billion cost at a minimum. And that is in a somewhat different category.

But, as you say, you know, when we think we've got everything up on the radar screen that might happen, events come on to the scene that are not foreseen or not anticipated.

Mr. HAVENS. That's right, Mr. Chairman. That's why we focus on the adequacy of capital issues, because that is the first line of defense. When you've got something that wasn't anticipated, something that wasn't compensated for, that's when you need capital.

The CHAIRMAN. Well, I think you have given us the assessment that we have asked you to do, and I appreciate the full statement that you have given to us.

I know some of my colleagues may have follow-up questions and, if so, we will submit those to you for the record.

Was there any other observation you wanted to make before we adjourn this morning?

Mr. HAVENS. I don't think so, Mr. Chairman.

The CHAIRMAN. Thank you very much.

The committee stands in recess.

[Whereupon, at 12:50 p.m., the committee was adjourned.]

[Response to written questions of witnesses and additional material for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PROFESSOR KAUFMAN

Question 1 - The Committee wants to do a good job of oversight over the banking industry. What is the best way, in your estimation, for the Committee to meet its responsibilities?

To hold hearings such as these that include reports by the bank regulatory agencies, the General Accounting Office, private bank credit rating firms and independent experts. The major problem involves interpreting the available data both for the banks and for the regulatory agencies. Greater reliance on market value reporting would be helpful and the Committee could encourage and speed up the introduction of such reporting by asking both the agencies and the independent experts to provide market value figures in their reports to the extent possible for both banks and the insurance agencies. The first time will be the hardest, but a start has to be made sometime and the sooner the better for the taxpayer.

Question 2 - Do you feel comfortable that the FDIC is moving quickly enough to close down insolvent institutions? If not, why not?

Not up to now. Table 3 in the testimony by Litan and Brumbaugh clearly show the large losses incurred by the FDIC by not closing marginally GAAP solvent but economically insolvent banks sooner during the six months from September 1988 to March 1989. These data are reinforced by the large losses the FDIC experienced in not closing the larger Texas banks more quickly in the last two years. As the FDIC continues to back away from the discredited "too large to fail" doctrine, it may be expected to move more quickly in closing and reorganizing economically insolvent institutions. Although the law still focuses on GAAP and not economic insolvency, the recently enacted FIRREA gives the insurance agencies additional powers to effectively act sooner.

Question 3 - The Shadow Group has contended that the FDIC's condition is weaker than the agency reports. It is difficult for Congress to judge the condition of the insurance agency. We had a similar situation in the S&L industry, where we were given conflicting reports about FSLIC's condition for several years. Clearly we need better information. How can Congress get a better understanding of the bank (and thrift) insurance funds in the future?

Professor Edward Kane, a member of the Shadow Financial Regulatory Committee, has recently testified on this question before the House Banking Committee. Rather than repeat his answer, I attach a copy of his testimony.

Question 4 - Evidence suggests that examiner resources are being stretched more and more thinly over the banking system. The situation is being exacerbated by the FDIC's diversion of resources to the RTC. Are you concerned that the agencies have insufficient resources to do an adequate job of examination, supervision and enforcement?

Yes. Part of the reason for this is insufficient funding and part lies in the failure of the examination/supervisory agencies to keep up with the dramatic changes in bank operations and technology that have changed the way on-site examinations need to be conducted. These changes have reduced the need for audits of individual accounts and have increased the need to audit control systems and evaluate the quality of the numbers reported by the banks. The changes introduced by the Comptroller of the Currency, as described in his testimony before the House Banking Committee on September 19, 1989, appear to be in the right direction. Unfortunately, because of its heavy new responsibilities, the FDIC may not only be stretched thinly but not advance as quickly. Thus, greater interagency cooperation in examination and supervision would be helpful in the next months. State examination practices also need to be improved. Beefing up examination is a worthwhile expenditure.

Question 5 - You favor early intervention and recapitalization for weak banks. Do you see any disadvantages or obstacles to implementing this proposal?

On net, there are no major disadvantages. There are a number of obstacles as would be expected with any radically new program. But they are not lasting. The responsible regulatory agencies would need to improve monitoring and the quality of reported data so that the true condition of the bank would be known in a timely fashion. It is also necessary for the agency to announce this new policy sufficiently in advance so that the institutions can prepare for it and its application needs to be phased-in over, say, three years so that the solvent banks currently not in compliance with the intervention and trigger values are given time to get their house in order. Moreover, although the trigger values for increased sanctions short of reorganization may, at first, be established on a more or less ad hoc basis, the final trigger value for reorganization and recapitalization needs to be established on the basis of evidence regarding the quality and timeliness of the reported bank data and the volatility of bank earnings. This requires additional research. The major obstacle, as always, is human reluctance to try something unfamiliar.

Question 6 - In your testimony you recommend that the government issue stock certificates to companies that continue to operate without any of their own capital.

This recommendation differs from the policy position adopted by the RTC and reported recently to this Committee. Secretary Brady said that the government should take warrants but not equity positions, because it should avoid downstate risks. Do you disagree with Secretary Brady and the RTC's position? If so, why? What are the advantages and the disadvantages for the federal government from taking equity positions in failed banks?

If an institution is economically insolvent and permitted to continue to operate, the government implicitly has an equity position in the institution. My proposal would only formalize this fact by giving the government the corresponding equity shares explicitly. This would permit the government both to control management and to be able to reprivatize the institution quickly by selling the shares. Warrants would not achieve the same goals. Although they would permit government to participate in any recovery by the bank, they would not provide the government with as much of the gain or as much control in the short-term and, more importantly, would make the reprivatization slower and more complex.

Question 7 - The regulators are phasing in risk-based capital standards. Do you think that risk-based standards are a good idea? Are you happy with the way they are being implemented? Are you concerned that the 50% weighting for single family mortgages will lead banks to do too much real estate lending?

Risk-based capital is not as important as the capital-asset or gearing ratio, particularly for the purpose of protecting the reserves of the federal deposit insurance agencies. The Shadow Financial Regulatory Committee has discussed some of the limitations of risk-based capital in its policy statement of February 8, 1988, a copy of which I attach. If deposit insurance is not underpriced and capital forbearance is not practiced by the regulatory agencies, the free market will inform individual banks how much capital they need to protect their uninsured depositors and creditors. The greater a bank's risk exposure, the larger the capital the market requires. The market, however, will not determine how much protection is required for the deposit insurance agencies. This needs to be determined by the agency itself. The amount is related more to the agency's ability to monitor the financial condition of the banks and to act quickly than to the riskiness of the banks. Thus, at least for the protection of the deposit insurance agency, if capital is to be scaled to any variable other than asset size, it should be scaled to the monitoring difficulty posed by the bank. But asset size is far simpler and just, if not more, effective for purposes of protecting the deposit insurer.

I am not concerned that the 50% capital weight will lead to too much mortgage lending. Rather, it may lead to too little capital in the banking system. To the extent that qualified capital is more costly, mortgage rates may be slightly lower with the 50% weight, but even a 100% weight would give the banks and thrift institutions an advantage over competitors not covered by the safety net.

Question 8 - Deposit insurance coverage is being extended by covering such products as Bank Insurance Contracts (BICs). Last year the FDIC proposed to further extend the definition of a deposit to cover promissory notes. What is your opinion about such extensions of deposit insurance coverage?

This, indeed any extension of deposit insurance coverage, is in the wrong direction. If it is not possible politically to roll back deposit insurance coverage, at minimum, it should not be broadened. The costs, in terms of losses to the deposit insurance agency, will greatly exceed any imaginable potential benefits. Recent history clearly attests to this.

Responses To Questions From Senator Cranston

Professor Kaufman

1. **The legislative effort of this past summer, FIRREA focused a good deal of attention on the need for responsible capital requirements for thrifts. With regard to the subject of capital for financial institutions generally, we have often heard that in today's global financial market, capital will "go where the action is".**

As you look at the modernization and restructuring that are taking place in the European financial markets and elsewhere, what do they portend for our own industry's ability to continue to attract capital in the future?

If banks are not restricted to a relatively unprofitable set of activities, they should be able to attract capital. If they were so restricted, unrestricted firms would spring up to provide the services demanded by the market place and would be able to attract sufficient capital, as many have in recent years. This process, however, would be inefficient as it would duplicate bank capacity already in place. But the most important reason for the lack of private capital in banking is not a restriction on activities. Rather, it is the current structure of federal deposit insurance which permits, indeed encourages, the substitution of public capital for private capital and the failure to recognize debt that is subordinate to the deposit insurance agency and the interest on which is tax deductible as capital. Thus, financial institutions that are not protected by the federal safety net, such as finance and insurance companies, have little difficulty in raising capital greatly in excess of that currently held by commercial banks.

Although I am in favor of new powers for commercial banks, these powers should be evaluated on their own merits. The banking policies of other countries should not be followed blindly. If, for example, other countries prefer to subsidize their banks or prefer to permit their banks greater economic power at the cost of possibly reducing economic efficiency, this should not mean that we should do the same. It would be also preferable to reform the deposit insurance safety net before expanding bank powers to avoid both subsidies and potential large losses to the insurance agency. In this respect, the timely regulatory intervention and recapitalization proposal that permits subordinated debt capital of the Shadow Financial Regulatory Committee would be efficient in simultaneously permitting expanded bank powers and improving the international competitiveness of U.S. banks.

2. **Can't we expect capital to follow opportunity, and in turn, go to the markets that offer the broadest range of activities?**

Capital follows expected risk adjusted returns regardless of the range of activities permitted. If activities permitted banks overseas are more profitable than activities permitted banks domestically, then capital would be attracted overseas. However, it is not in the best interests of the U.S. to attract private capital to banking in the U.S. at the expense of the taxpayer.

As noted above, it would be preferable to permit the market to determine how much capital could be used by U.S. banks under conditions of fairly priced deposit insurance and minimum restrictions on bank powers.

3. The DIAA, S.530, introduced by Senators Garn, D'Amato and me sets up a system of functional regulation whereby each financial activity is supervised by the appropriate federal regulator according to the nature of the activity itself. Do you believe it is in this country's interest to move toward such a system of functional regulation?

I defer to those more expert then I am on this question. It is, however, more important to put in place the correct incentive structure towards risk taking by banks than to be concerned about what agency regulates what activities.

4. What do you deem to be the single biggest challenge our financial services industry faces as we enter the next decade?

The single biggest challenge facing the financial services industry in the next decade will be incorporating the tremendous technology changes occurring in the transfer of funds across great distance, at great speed and at low cost. These changes have important implications for competition both among banks located anywhere, including overseas, and from nonbanking firms, who have the same computer and telecommunication equipment as the banks. Similar to the technological challenges faced by the electronics and telecommunications industries in recent years, banking faces the most serious technological challenge in its history. The technological advances promise to dramatically alter the way banking business, particularly at the wholesale level, is conducted. Competition will be more intense than ever. In such an environment there will be winners and losers, as in the other industries, but the losers must be permitted to exit for efficiency to be achieved. The technological advances will also force equally dramatic changes in supervision and regulation, so that the pressures on the regulatory agencies to remain efficient and effective in such an environment will be as great as on the banks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

JAMES GILLERAN

Q1. We just finished passing major legislation to provide funds for the resolution of insolvent thrift associations. Many believe that a good deal of the problem in the thrift industry may be traced to over-liberal State legislation, especially laws in such States as Florida, Texas and California. These States acted as early as 1980 to dramatically increase the powers of their State chartered institutions, at times putting Federally chartered institutions at a competitive disadvantage through their actions. To a large extent the FIRRE Act responded to this problem by giving the FDIC enhanced authority to regulate State granted powers that went beyond the powers authorized for Federal thrift institutions under the National Housing Act and the Garn St Germain Act.

– To what extent did your State provide state banks with asset powers in the early 1980s comparable to those given to your state thrift institutions? Have there been abuses associated with these powers, and if not, can you explain why not?

1: In 1982 the State Legislature passed a bill granting California state-chartered banks the authority to engage in real property investment and development, and to invest in equity securities. The authority was effective January 1, 1984. During 1984, the Legislature amended the authority by requiring State Banking Department approval before a bank exercised the authority and imposing other limits on the activity.

The experience of California state-chartered banks in real estate investment has been quite successful for a number of reasons. While California savings and loans were granted the authority to invest in real estate across the board, banks have been required to demonstrate the financial and managerial capacity to carry out these investments. The approval process requires the bank to submit a business plan for the intended activity. The past operating history of the bank is considered in the evaluation, and only those banks satisfactorily rated, CAMEL 1 and CAMEL 2, are approved by the Department. After initial approval, these activities are monitored through the addition of a special schedule tracking these investments as part of the Department's Quarterly Call Report, and a special examination program. The State Banking Department takes prompt action, including cease and desist orders, against any bank deemed to be conducting its operations in an unsafe manner.

Our experience shows that banks have exercised this power in a very conservative manner. A few banks have incurred minor losses, but none have caused a serious decline in the bank's condition and none have been the cause of any bank failure. In general, the new powers have made a positive contribution to the performance of the banks which utilize the authority.

Congress has been critical of expanded powers for banks, based primarily upon the experience with savings and loan associations and the massive losses they have encountered. However, the situation here in California is quite different. We have restrictions on which banks may engage in the power; application procedures; investment limitation amounts; continuing examination procedures; and a tracking system for those using the power. These procedures and our experience is quite different to the savings and loans situation.

Q2. State banking regulatory agencies (like Federal banking agencies) often receive funding primarily from examination fees assessed on State chartered institutions. If there is a decline in the number of such institutions, the funds available to the State agency declines, while if there is an increase in the number of such institutions, the budgets of the regulatory agencies will grow.

– Does this situation lead to a conflict of interest, in that there is an incentive for the banking agency to encourage institutions to seek State charters through more liberal supervision or regulation?

– Has this been a problem in the past in your State?

– Since the same incentives may well apply at the Federal level, do you feel that a similar problem exists with the Federal banking agencies? If not, why not?

– In what ways can State or Federal banking agencies maintain or achieve more independence from the industry they regulate?

2: California funds its Banking Department through an annual assessment based upon the total assets of each licensee. The formula for this assessment is similar to that utilized by the OCC, and is assessed whether or not the bank is examined during that year.

We have determined that, on an annual basis, our larger banks pay more in their assessment than it costs to examine them. Conversely, many small banks pay less in assessment than the cost to examine them. Therefore, it would be a disincentive under our assessment system to encourage more new (and smaller) banks. The method of funding this Department does not lead to a conflict of interest. The Department maintains a reserve to offset a possible decrease in assessment revenue resulting from State Bank conversions. The reserve, if needed, would allow the Department time to adjust expenses in the event the number of our banks or assessment base decreased.

The State Banking Department is subject to checks and balances designed to prevent undue influence from the industry. The Superintendent of Banks is appointed by the Governor, subject to confirmation by the State Legislature. The Department is specifically subject to oversight by the Assembly Finance and Insurance Committee and Senate Banking and Commerce Committee. We are frequently called upon to report to these committees. Also, we are cognizant of the supervisory function provided by the Federal Deposit Insurance Corporation as the insurer of our State Chartered Banks. The confirmation and oversight procedures are similar to the checks and balances applied to other state and federal agencies funded by general tax revenues.

As a Certified Public Accountant for over 30 years, I recognize the importance of independence in our role as regulators. The Department staff takes great pride in its professional attitude and views independence as the "sine qua non" of its professionalism. We see ourselves as representing the people of The State of California, not the banking industry exclusively.

This independence and professionalism can be seen in our attitude towards banking legislation. The Department has opposed numerous bills proposed by banking organizations. For example, the banking industry sought "across the board" powers to invest in real estate. The Department requested and received language in the statute limiting this activity that has ultimately resulted in the successful implementation and integration of this activity in the California banking industry.

Thus, although the Department is funded by industry assessments, the checks and balances such as confirmation procedures and legislative oversight coupled with the Department's professional attitude result in a department that is independent from the industry. In our opinion we do not see a problem with this method of funding at the state or federal level.

Q3. One of the more significant issues raised in the savings and loan debate concerned capital standards, and the appropriate level of capital for thrift institutions. Following the passage of the legislation, a debate broke out among the Federal regulators as to the appropriate level of capital that should be required of banks.

– Do you believe that the banking industry is sufficiently capitalized?

– Do you favor increasing or decreasing capital levels?

– Do you agree with the position that a 6% non-risk adjusted capital requirement should still be mandated after the risk-adjusted capital standards go into effect?

3: The FDIC shows a 6/30/89 aggregate equity capital to total asset ratio for all U.S. banks of 6.44%. Uniform Bank Performance Report figures for the same period show the average equity capital ratio for all banks to be 8.67%. In California, state chartered banks have an aggregate equity capital ratio of 6.7%, and an average equity capital ratio of 9.28%. In our opinion, the banking industry is sufficiently capitalized.

As noted above, we believe the industry as a whole is sufficiently capitalized, and favor neither increasing nor decreasing capital levels "across the board". Benchmark figures while useful do not fit the situation of every bank. Depending upon the market a bank serves, its portfolio mix, capability of management, earnings history, and projected growth, etc., a particular bank may need more or less capital than a nearby competitor, and the proper level should be determined by the appropriate regulator.

Our view on the disagreement between the FDIC and the OCC as to the appropriate level of capital is more in line with that of the OCC. We are in favor of going to the risk based capital standard adopted by the federal agencies. We also agree that there should be a minimum (a "floor") of equity capital that no bank should be permitted to sink beneath. This "floor" must not be permitted to become the standard. Banks should be required to meet the risk based standard, and if they approach the "floor" should be evaluated on a case-by-case basis to determine what, if any, additional equity capital is needed. In our view, to simply retain the 6% leverage capital standard and also require meeting the risk based standard is inappropriate. The recent proposal by the Federal Reserve Board to set a 3% "floor" for CAMEL 1 banks, with a 100 to 200 basis point increase for other banks, seems to us to be an acceptable compromise.

We believe, however, that there should be generally the same capital standard for state as well as national banks.

Q4. Some States have recently received the authority to engage in real estate investment and development either directly or through a subsidiary. Do you permit banks in your State to engage in these activities? If so, what was the policy justification for this authorization? Do you have concerns about these powers? Are you aware of other States which have taken similar action?

4: 1982 Legislation, effective January 1, 1984, permitted state chartered banks to invest in, develop, own and sell real property. The authority is limited to 10% of the assets of the bank when the activity is conducted through subsidiaries and limited to total shareholders equity when undertaken directly.

The enabling legislation contained a "Legislative Intent" section as follows: (1) That it is necessary to increase job opportunities in real estate development and construction and to provide additional housing and commercial facilities in this state. (2) That within the commercial banking community there exists the expertise and ability to promote and assist in expansion of real estate development projects in this state. (3) That it is proper and appropriate to utilize that expertise and ability by authorizing commercial banks to engage in real estate development and management on an entrepreneurial basis.

Any initial concerns we had have been mitigated by our experience over the past five years. Generally, California banks have used the power conservatively, and the majority report profitable real estate ventures.

Q5. What securities underwriting, real estate investment and development and insurance powers are banks in your state allowed to engage in and how are those powers regulated, i.e., by quantitative limitations, firewalls or other regulatory restrictions, separate affiliate requirements, capital requirements, etc.?

– What is the extent of the activity undertaken under these permitted powers by your state's banks? For example, how many banks engage in these activities? What is the approximate dollar volume?

– As the state bank regulator do you have a means to monitor which state banks enter into each of these activities? For example, are state banks required to submit a request to enter into specific securities, real estate or insurance activities or a proposed plan prior to commencing such activities to the state bank regulator prior to approval?

5: Banks have no specific authority to underwrite securities under California law, and furthermore would be subject to Glass-Steagall. Real estate investment and development is covered elsewhere in this response. In November of 1988, California voters approved Proposition 103 which, among other things, gave state banks general authority to sell insurance (in addition to credit life and disability, which they already had).

Real estate investment is controlled through an application process to the Superintendent, and through specific quantitative limitations. We have also requested all banks to adopt a specific policy governing insider transactions. Insurance is limited to sales activity, and as a result carries limited risk to the bank. Banks are required to be licensed by the Department of Insurance, and must provide the State Banking Department with a comprehensive business plan of their activities.

As of 6/30/89, only 77 of our 270 banks engaged in real estate investment activities, having invested $268 million, or less than 1% of their aggregate assets. To date, only 14 banks have obtained licenses from the Department of Insurance to sell other than credit life and disability insurance.

Q6. I am interested in you observation that the capital ratios declined at an alarming rate during the last year of a failing bank. Robert Litan's recent testimony before this Committee made a similar point.

– Why does this happen?

– Does it mean that we should close banks before insolvency?

– Does this mean that we should move to market value accounting?

6: A major reason for the steep decline of capital is that the problem bank has usually reached a stage where losses far exceed new capital injections. Additionally, the growth in assets at problem banks was higher than healthy banks, further exacerbating the decline in capital ratios. The rapid growth in assets were also in very risky endeavors. Additionally, legal and other consulting fees added to the heavy losses already being incurred.

The California Superintendent of Banks does not necessarily wait until a bank becomes insolvent before closing it. Under Section 3100 of the California Financial Code a bank may be closed under any one of eight standards, as follows: (a) The contributed capital of any bank is impaired; (b) Any bank has violated its articles or any law of this state; (c) Any bank is conducting its business in an unsafe or unauthorized manner; (d) Any bank refuses to submit its books, papers, and affairs to the inspection of any examiner; (e) Any officer of any bank refuses to be examined upon oath touching the concerns of such bank; (f) Any bank has suspended payment of its obligations; (g) Any bank is in such condition that it is unsound, unsafe, or inexpedient for it to transact business; or (h) Any bank neglects or refuses to observe any order of the superintendent made pursuant to Section 1913 unless the enforcement of such order is restrained in a proceeding brought by the bank.

We do not favor full market value accounting, since if assets and liabilities can and are planned to be held for long periods, fluctuations are injected into financial accounting that will not be realized.

Q7. What effort is your State making to detect bank fraud, prosecute criminal misconduct, and prevent unsuitable persons from entering the banking industry as owners, directors or managers?

7: Our department recently received legislative approval for two investigator positions. These employees will have the power of arrest, the power to serve search warrants, and will have access to criminal records at the California Department of Justice.

These positions will investigate and enforce violations of the various laws administered by this department, will develop cases to the point that they may be presented to the Attorney General or District Attorney, and in addition will investigate the backgrounds of persons applying for bank charters or other licenses issued by the banking department.

Q8. Have recapitalizations of troubled banks been successful in your State? If not, why not?

8: Although difficult, it has generally been possible to raise additional capital for state chartered banks. Banks needing additional capital (whether voluntarily or as a result of a regulatory order) are required to obtain a permit from the banking department. The process of selling securities includes a thorough review by the banking department legal staff, including whether the prospectus presents fairly the condition of the bank.

Banks under regulatory orders must disclose that fact in their prospectus, making it difficult to sell stock to the public. Many times the current directors or controlling shareholder(s) are the only source of additional capital.

Additional difficulty in selling bank stock over these past few years has been exacerbated by national media coverage focusing on the banking and savings and loan industries, with special emphasis on unprofitable, problem or insolvent financial institutions.

Vice Chairman Johnson subsequently submitted the following in response to written questions from Chairman Donald W. Riegle, Jr., in connection with the hearing held on October 25, 1989:

Question 1: Mr. Kenneth Littlefield, Banking Commissioner for Texas, spoke persuasively in our October 17 hearing, about a new forward-looking, flexible system of examination and supervision in Texas. One element in this approach is concentration on "leading indicators" of condition (such as, high growth rates or dramatic changes in portfolio composition, management objectives or procedures). A second aspect is flexibility in examination and supervision. An experienced examiner is given a portfolio of banks to monitor continuously off-site rather than examine on-site periodically according to a fixed schedule. A third part is a system for evaluating management capabilities and performance.

Does the Federal Reserve favor this approach? Has it adopted, or does it plan to implement the approach? If so, when? If not, why not?

Answer: The Federal Reserve agrees that certain indicators, such as high growth rates and changes in asset mix, can serve as useful signals for planning supervisory actions, including the conduct of on-site examinations. For this reason, Board and Reserve Bank supervisory personnel monitor these and a host of other financial and operating factors -- such as earnings, nonperforming loans, capital, and significant changes in management personnel and philosophy -- to determine the condition of banking organizations and the need for any new supervisory responses, including the timing of examinations.

While we recognize the benefits of a flexible approach to supervision and employ off-site monitoring as an integral element of our supervisory programs, we do not believe that off-site surveillance can substitute for a regular program of periodic on-site examinations. In our view, on-site examinations, involving a careful review of the asset portfolio, are necessary to obtain an accurate assessment of the quality of a banking organization's loans and investments, the effectiveness of its internal operating controls and procedures, its compliance with banking laws and regulations, and the adequacy of its management. In short, we firmly believe that periodic on-site examinations are an essential feature of an effective supervisory program.

Question 2: Issuing a capital directive to an undercapitalized institution is one way to express your agency's concern over capital adequacy. Please state the number of capital directives issued by your agency in the last three years, and indicate the number and percentage of the current caseload of problem institutions that have received a formal capital directive. Please explain the general policy and procedural requirements for your agency's issuance of capital directives. Can your agency use capital directives to prevent future insolvencies?

Answer: The Federal Reserve has authority to take any of several formal enforcement actions against member banks or bank holding companies that do not have adequate capital positions. These actions include the issuance of a cease and desist order, the execution of a formal written agreement, or the issuance of a capital directive.

The Federal Reserve employs cease and desist orders and formal written agreements, rather than capital directives, to address capital deficiencies and other unsafe or unsound banking practices or violations of the law by institutions it supervises. Orders and agreements are used because they can accomplish the same results with respect to capital deficiencies as can capital directives, and have further benefit of enabling the Federal Reserve to address a wider array of supervisory problems. Our experience to date is that troubled financial institutions with a capital deficiency, generally have other important weaknesses such as inadequate internal controls or lending policies that led to their capital problems. Since, by law, capital directives can be used only to remedy a shortage of capital, the Board has felt it necessary to use these broader powers.

Since the beginning of 1987, the Federal Reserve has issued or executed 37 cease and desist or formal written agreements against state member banks and a total of 41 against bank holding companies. Additionally, the Board issued three temporary cease and desist orders against bank holding companies. In all of the cases that involved a capital deficiency, the order or agreement required the institution to submit a capital enhancement plan that was acceptable to the Federal Reserve, along with other plans, policies and procedures aimed at correcting the underlying causes of the institution's problems. Such capital enhancement plans describe the sources and timing of all necessary capital injections in the same manner that a capital directive would if this more limited enforcement tool were used.

Question 3: The savings and loan industry was decimated by losses on loans secured by real estate. Many of these loans were nonrecourse loans with high loan to value ratios. Real estate lending by banks has increased dramatically in the last five years. It has been argued that any problems associated with real estate lending by banks would be better addressed by regulation not legislation. What steps are you taking to prevent unsafe and unsound real estate lending, and specifically, what regulatory initiatives do you have planned to deal with the risk of real estate loans with high loan to value ratios? Several large Southwestern and New England banks have established surprisingly large loan loss reserves for real estate loans. Have the real estate losses been adequately addressed by the banks in your jurisdiction or will there continue to be future surprises?

Answer: Many banking problems have resulted from excessive or imprudent real estate lending. As with any loan, the quality and performance status of a real estate loan is a function of the adequacy of the borrower's cash flow. With respect to most commercial real estate loans, the borrower's creditworthiness is largely determined by the cash flow generated by the asset(s) supporting or securing the extension of credit. In assessing the condition of real estate loans, therefore, the Federal Reserve seeks to ascertain that credit decisions were predicated upon the existence of reliable sources of cash flow based upon current or reasonably expected economic conditions, rather than upon speculative assumptions regarding possible future inflated price levels or unrealistic income projections. Loans whose repayment is not supported by reliable sources of cash flow, as well as loans with excessively high loan to value ratios or inadequate collateral, are criticized by examiners and, if deemed sufficiently troubled, the establishment of appropriate loan loss reserves is required.

Within the last several years, the Federal Reserve, in conjunction with the other banking agencies, has taken several steps to address problems associated with real estate lending. In particular, the banking agencies have adopted policies calling for banks to establish adequate programs for the conduct of real estate appraisals by individuals who are both qualified and independent of the lending function. In addition, the agencies have adopted guidelines for the assessment of troubled commercial real estate loans and collateral by examiners or supervisory personnel if the bank does not have an adequate and realistic appraisal or evaluation on file. The banking agencies are also working to implement those provisions of FIRREA that call for strengthening the oversight of the real estate appraisal industry and improving the quality of real estate appraisals. In addition, it should be noted that the FIRREA Conference report states that the banking agencies should establish reasonable standards for real estate loan to value ratios.

Troubled real estate loans have been problems for several banks in the Southwest, Northeast, and in other parts of the country as well. It is, of course, not possible to say that further losses will not emerge at some institutions given the risk characteristics of real estate lending and the potential impact of changing economic conditions on real estate markets and portfolios.

Question 4: Do you believe that a definition of solvency based on the fair market value of a financial institution's assets and liabilities would promote the safety and soundness of the banking system?

Answer: The definition of solvency is an important indicator for supervisory purposes -- both because it reflects the condition of a banking organization, and because it is a key determinant of when a bank should be closed. Solvency measures should be accurate and truly reflective of the value of assets if banking organizations are to be closed in a timely fashion with minimal risk to the deposit insurance funds.

The most important way to maintain the integrity of solvency and capital ratios is to assure that assets are valued on a prudent basis in accordance with acceptable accounting principles. In the case of banking organizations, a number of steps are necessary to achieve this result. First, assets that are held for trading purposes, or with the intent to sell, should be valued at market or the lower of cost or market as called for under GAAP. This will prevent the build-up of unrecognized trading losses that could allow a bank to assume risks based upon a weak or exhausted capital base. Second, the loan portfolio should be adjusted for credit quality purposes in a timely fashion through write-offs of uncollectible assets or through the creation of appropriate loan loss reserves for estimated future losses. This process can be facilitated and assured through effective on-site examinations, monitoring and supervisory follow-up procedures designed to require banking organizations to recognize their problem loans and adequately address their asset quality weaknesses. While the absence of effective markets for many types of loans and other bank assets precludes the adoption of full current or market value accounting, appropriate adjustments for credit quality can assure that capital adequacy ratios and solvency measures reflect more accurately the true financial health of banking organizations. Under these conditions, these measures will better promote the safety and soundness of the banking system in two ways. First, by giving a better indication of bank condition, they will help regulators determine when necessary supervisory actions, such as requirements to slow growth or raise new capital, should be taken. Second, effective measures of insolvency will allow regulators to close institutions in a timely fashion, thereby limiting risk to the deposit insurance system.

Question 5: What improvements do you feel that you need to make in your system of regulation, examination, supervision, and enforcement? When do you plan to implement these improvements?

Answer: Vice Chairman Johnson's testimony addressed a number of steps the Federal Reserve has taken to strengthen the supervision of banking organizations. In light of increasing risks, both domestically and internationally, the Federal Reserve has, throughout this decade, urged banking organizations to strengthen capital positions and loan loss reserves and to review dividend practices with the goal of raising earnings retention where necessary. Moreover, in recent years the Federal Reserve, in conjunction with the OCC and FDIC, reached agreement with bank supervisors in foreign countries with major banking systems on the establishment of risk-based capital standards and is in the process of implementing the standards. The standards are designed to better relate bank capital requirements to overall credit risk exposure and to factor explicitly off-balance sheet risk into capital adequacy assessments. The agencies have also adopted procedures for identifying and evaluating highly leveraged transactions (HLTs) that will be employed in the examination process to assess HLT exposure and to encourage banking organizations to establish appropriate policies and systems to monitor and control their risks to highly leveraged borrowers. The Federal Reserve has also adopted examination guidelines to focus examiners' analyses of HLT loans on the adequacy of the borrower's cash flow based upon demonstrable and reliable sources of income, rather than upon unrealistic projections or speculative increases in cash flows or asset prices.

Within the last several years, the Federal Reserve has augmented its field examination force and increased the frequency of on-site examinations. It has also continued to vigorously pursue appropriate enforcement actions for unsafe and unsound banking practices. The System intends to continue to implement these programs. The Federal Reserve also intends to review whatever steps are necessary to hire and retain qualified field examiners and supervisory personnel in order to assure the quality and effectiveness of its supervisory programs.

Question 6: What actions and decisions that you now take independently would be better if coordinated with your fellow regulators?

Answer: The Federal banking agencies have long coordinated their activities on a wide variety of supervisory, examination, enforcement, and financial reporting matters. Recently, the banking agencies have been meeting regularly to discuss issues relating to the implementation of the recently-adopted risk-based capital guidelines. In addition, the enactment of FIRREA will initiate a number of other efforts to coordinate important regulatory initiatives. These include the adoption of regulations pertaining to the use of appraisals by banking organizations, monitoring state activities to certify and regulate real estate appraisers, the development of consistent capital standards, the coordination of accounting and reporting procedures for the purpose of assessing capital adequacy, and encouraging the strengthening of financial institution credit extension policies.

Question 7: Recently, several money center banks have substantially increased their loan loss reserves. Are the loan loss reserves held by U.S. banks against their LDC loans adequate? Will you require/encourage banks to increase the reserves they hold against LDC loans? Or will you discourage them? What impact will the increase in reserves have on the Brady Plan?

Answer: With the recent increase in loan loss reserves by a number of major money center banks for their loan exposure to countries with debt servicing problems, most U.S. banks now have reserve levels that are at or above international norms. With reserves at these higher levels, banks are in a better position to work with developing countries to help improve their ability to service their debts, as envisioned by Secretary Brady.

U.S. banks with reserve levels below those of their peers need to reevaluate their overall capital levels in relation to their developing country loan portfolios to ensure that their reserves and capital positions are adequate in light of changing circumstances. Furthermore, the Federal Reserve will continue to encourage banks, whenever necessary, to augment their reserves and capital levels in an orderly manner over time.

Question 8: Are you comfortable with: (a) the loan underwriting capacity of the banks that purchase portions of the senior debt that is originated by the large banks in LBO and other highly leveraged transactions; (b) currently applicable accounting principles that govern how banks book the commitment and other fee income associated with their origination of LBO and other highly leveraged transactions; (c) the methods banks use to determine their provision for loan losses on LBO and other highly leveraged transactions? What steps are you taking to remedy any deficiencies?

Answer: (a) As with other types of loans, the policies and procedures for purchasing HLT loans vary among banking organizations. Some institutions have implemented more effective systems than others for assessing the quality of purchased credits and monitoring their performance. The Federal Reserve has urged banking organizations that are buying credits originated by others to apply care and prudence, particularly with respect to conducting an independent and thorough assessment of any credit purchased from another banking organization.

(b) In general, banks appear to be following accounting principles established under GAAP for the recognition of HLT fee income. However, conventional accounting principles do allow the recognition of some fees up-front. The Federal Reserve believes that it is important that banking organizations not allow their credit judgment to be unduly affected by the prospect of such fee income. For this reason, System examiners assess the recognition of HLT fee income, as well as the overall HLT credit approval process, in order to determine if prospective loans are subject to appropriate credit review and approval procedures based upon the creditworthiness and demonstrated cash flow of the borrower, rather than upon the prospect of up-front fees.

(c) Banks are expected to maintain reserves and capital positions consistent with their overall risk exposure, including their holdings of HLT credits. In this case, too, banks vary with respect to the adequacy of their reserve and capital levels. In some cases, reserves appear reasonable given current conditions; in other situations, however, reserves need to be strengthened. Those banks found to have deficient or inadequate reserves are encouraged to boost their provisions for loan losses and, when necessary, also take steps to strengthen their equity capital bases.

A copy of the Federal Reserve's examination procedures for assessing HLT and LBO credits is attached.

Question 9: The recent S&L legislation enables the FDIC to force one bank in a holding company to reimburse the FDIC for the losses caused by another, failing member. Some people ask if this provision is equitable. Are you satisfied with the way this provision is working? Do you expect to have problems with its implementation?

Answer: This legislation recognizes that subsidiary banks of bank holding companies are controlled by a common parent and that their activities are typically closely linked. Thus, the legislation is intended to prevent a holding company from concentrating its weak assets in one office or group of offices and, by letting it fail, divorce itself of any responsibility or financial burden, while continuing with its normal banking activities. Such actions would not be possible if the company were operating through branches and should be strongly discouraged when it operates through subsidiary banks.

We would note, however, that the cross-guarantee provision appears not to apply to subsidiaries of commercial banks. Accordingly, while the FDIC's claim against any insured depository institution for loss reimbursement under the statutory cross-guarantee provision is superior to any claim of the shareholders or affiliates of such institution, the statute contains no similar provision for claims against the subsidiary of an insured depository institution. This lack of express statutory authority could impair the ability to have a superior claim on significant assets of the banks. Recently, for example, a United States District Court held that where the subsidiaries of a thrift institution had filed for bankruptcy, the fact that the RTC was acting as conservator for the parent thrift institution did not supplant any portion of the Bankruptcy Code. Accordingly, absent an express Congressional statement to the contrary, the court would not repudiate the application of the Bankruptcy Code by treating the thrift's subsidiaries as "assets" subject to the RTC's jurisdiction. Similarly, another United States District Court has taken the position that its bankruptcy jurisdiction permits it to displace the Board's supervisory authority over bank holding companies and thus to restrain the Board's prosecution of ongoing enforcement proceedings.

Such applications of the Bankruptcy Code could complicate the FDIC's ability to obtain the assets of a particular bank in order to reimburse the insurance fund for any losses resulting from the failure of an affiliated insured depository institution.

While the cross guarantees provide a means of reimbursing the FDIC for losses incurred by the failure of an insured bank within a holding company from an affiliated bank, the Board has taken the further position that all assets of bank holding companies, including those in nonbank subsidiaries, should be available to provide financial support to troubled or problem subsidiary banks. For instance, in its Order allowing bank holding companies to establish Section 20 subsidiaries to engage in a broad array of securities underwriting and dealing activities, the Board specifically stated that bank holding companies should be expected to sell or otherwise dispose of those subsidiaries if necessary for the bank holding company to serve as a source of strength to its subsidiary banks or thrifts.

To date, this provision of FIRREA has been used only once to resolve a failed bank; so there is only limited experience with the way it has been or will be implemented. Nevertheless, the Federal Reserve strongly supports efforts to ensure that bank holding companies and their subsidiaries serve as a source of strength to troubled subsidiary banks.

Attachment to Question 8

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

February 16, 1989

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Highly Leveraged Financings

Highly leveraged financings (HLFs), including leveraged buyouts, have become an increasingly important and prevalent technique for financing acquisitions and for other purposes. Participation of banking organizations in such activities is not considered inappropriate so long as it is conducted in a sound and prudent manner. However, the involvement of banking organizations, including commercial banks and their holding company affiliates, in highly leveraged financing arrangements may have significant implications for the quality of their asset portfolios and their overall levels of risk exposure.

HLFs involve many of the same characteristics and risks that have traditionally been evaluated by supervisors during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt, economic conditions and trends, the individual borrower's future prospects, the quality and continuity of the borrower's management, and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes HLFs from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Banking organizations participate in HLFs at a number of levels. First, banks, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of an HLF. In addition, banks, bank holding companies and/or their nonbank subsidiaries may take equity positions or extend credit on a subordinated basis (mezzanine financing). Bridge loans represent one type of subordinated financing that is generally unsecured and depends on the successful marketing of longer term securities or the sale of assets for repayment. Finally, bank holding companies may invest in LBO funds that are managed by investment banking companies or other third parties.

To the extent that high leverage increases the vulnerability of borrowers to adverse market and financial developments, HLFs have the potential to raise the level of risk in bank loan portfolios. For these reasons, the Federal Reserve has actively urged bank management to exercise caution and apply especially rigorous lending and investing standards in participating in LBOs and other highly leveraged transactions.

In general, banking organizations involved in HLFs are expected to i) evaluate the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline; ii) set reasonable "in-house" limits on a consolidated holding company basis regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations resulting from HLFs; iii) establish credit analysis, approval and review procedures that take account of the high levels of debt involved in these transactions; iv) maintain internal systems, controls and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits, and keep senior management and the directors adequately informed on a timely basis of the organization's involvement in HLFs; v) establish pricing policies and practices that take account in a prudent manner of the tradeoff between risk and return; and vi) avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees.

Banking organizations should establish appropriate policies, procedures and controls before becoming involved in HLFs. In addition, significant policies and procedures, including internal lending limits and credit review and approval procedures, should be approved and reviewed periodically by the organization's board of directors.

Bank holding company HLF exposures should be monitored on a consolidated basis and should take account of loans and holdings of debt and equity securities issued in connection with HLFs, as well as any ordinary business loans to the same obligor. In addition, each holding company subsidiary participating in a HLF should establish reasonable exposure limits and appropriate credit review and approval procedures that call for an independent appraisal of the loan or investment. In particular, banks making loans to borrowers whose obligations are being underwritten by securities affiliates have an obligation to make a complete and "arms-length" assessment of the credit risks in accordance with the provisions spelled out in the Board's Section 20 orders.

Banking organizations purchasing participations in HLFs originated by other firms have the responsibility to make their own thorough and independent evaluation of the transaction and the risks involved before advancing any funds. Once the participation is purchased, such organizations should carefully monitor the borrower's performance throughout the life of the loan. All institutions engaged in highly leveraged financing transactions must assure that related fees and commissions are accounted for in accordance with generally accepted accounting principles. Finally, banking institutions engaged in these transactions should maintain loan loss reserves and capital positions that are fully adequate, given the nature and composition of their HLF portfolios, as well as their exposures to any other borrowers with significant leverage.

In view of the recent increase in the volume and size of LBOs and other restructuring transactions, HLFs continue to warrant the close attention of bank and holding company managers and directors. Such transactions should also continue to be carefully reviewed during on-site examinations and inspections. This is particularly important since the performance of these loans generally has not yet been tested in a period of economic decline. Any significant portfolio risks need to be identified and brought to the attention of senior management and the directors. In addition, any weaknesses in lending and underwriting standards or practices, or deficiencies in internal review, approval and control mechanisms, need to be addressed.

In the course of on-site examinations of banks and bank holding companies, examiners should review the organization's overall involvement in HLFs, as well as the individual loans and other forms of exposure associated with these transactions. The attachment to this letter sets forth general examination guidelines intended to underscore and supplement existing loan review procedures. Significant deficiencies or risks regarding a banking organization's HLFs should be discussed on page one of the examination report and brought to the attention of the board of directors.

The general criteria for identifying HLFs for examination purposes are set forth in the attached examination guidelines. In brief, HLFs are defined as exposures that meet two conditions. First, the exposures comprise loans and other claims assumed in connection with corporate restructurings, such as leveraged buyouts and similar transactions and corporate acquisitions or mergers funded with borrowed money. The definition also includes significant stock buybacks and cash dividends funded with debt. Second, HLFs are deemed to involve loans and other exposures to borrowers whose total debt-to-total assets ratios exceed 75 percent. In addition to this general leverage criterion, examiners may also consider the norms and standards for leverage in particular industries, as well as the cash flow-to-debt service coverage in individual transactions in determining what constitutes an HLF.

It is important to stress that these criteria are general guidelines. They are not meant to imply criticism of any particular transaction, nor to suggest what is deemed to be an appropriate degree of leverage in any particular industry.

Rather, the guidelines represent an additional tool to assist examiners in identifying in the first instance exposures that may warrant closer scrutiny. Any criticisms of specific transactions should be based upon an in-depth evaluation of all of the factors affecting the quality of the exposure, including the adequacy of the borrower's earnings, cash flow and collateral, as well as the quality of the borrower's financial, managerial and operating performance.

The attached guidelines, which supersede the Federal Reserve's SR letter on leveraged buyouts dated June 7, 1984, may be revised or refined in the future in light of changing conditions or practices within the banking industry.

William Taylor

William Taylor
Staff Director

Attachment

Attachment

EXAMINATION GUIDELINES REGARDING HIGHLY LEVERAGED FINANCING TRANSACTIONS

General comments regarding the definition of HLFs

- Examiners should review an organization's internal definition of HLFs to determine whether it reflects the risk factors associated with these transactions.

- For purposes of assessing an organization's HLF activities in examination and inspection reports, HLFs are defined as exposures that meet both of the following two conditions: First, credit is extended in connection with an acquisition by, or a restructuring of, the organization. Typically, such credits are extended to enable the employees, management, directors, or outside investors, acting individually or jointly, to gain effective control of an organization through the purchase of stock and/or acquisition of assets. Thus, the definition includes leveraged buyouts and similar transactions, as well as corporate mergers and acquisitions funded by debt. Significant company buybacks of stock and large cash dividends financed through borrowings may also be included. Second, the extension of credit results in "high leverage" or is made to an already highly leveraged organization. As a general guideline, high leverage is defined for this purpose as a total debt-to-total assets ratio exceeding 75 percent. In addition to this leverage benchmark, examiners may also take account of the norms and standards for leverage in a particular industry as well as the cash flow-to-debt service coverage for a particular transaction in determining what constitutes an HLF.

- Total exposure to individual HLF borrowers includes all loans, extensions of credit, and debt and equity securities relating to acquisitions or restructuring transactions, as well as any ordinary business loans to, or investments in, the same obligor. Total exposure also includes standby letters of credit, legally binding contractual commitments, and other financial guarantees.

- Loans or exposures to any obligor in which the total financing package (including extensions of credit by all participants) did not exceed $5 million at the time of origination may be excluded from the definition of HLFs.

- These guidelines are not meant to suggest that loans or exposures meeting the HLF definition should necessarily be criticized or deemed to involve excessive risks. Nor is the 75 percent debt-to-assets benchmark intended to reflect what is considered high or abnormal leverage in all industries. Rather, the definition is intended to provide guidance to examiners for identifying in the first instance certain exposures that may warrant further scrutiny and to do so on a consistent basis across banking organizations. The analysis of a borrower's financial position should take account of both the absolute level of the borrower's leverage ratio, as well as how the borrower's leverage compares to conditions and norms within the particular industry. Any criticism of exposures stemming from HLFs, like all other credits, should be based on the examiner's evaluation of all relevant credit factors, as well as on the guidelines set forth below.

Policies and procedures

- Examiners should review an organization's policies and procedures to ensure that: i) credit evaluation involves an independent assessment of the adequacy of the borrower's current cash flow and collateral values and the projected values under varying economic and interest rate assumptions, including the possibility of an economic decline; ii) the organization has established reasonable "in-house" limits regarding exposure to individual borrowers, total exposure to all HLF borrowers, and industry concentrations; iii) credit decisions on significant HLFs are made and monitored at appropriate senior management levels; iv) management reporting systems and controls are adequate to monitor the condition of individual HLF borrowers, as well as the organization's compliance with internal policies and lending limits; and v) timely and adequate reports are provided to senior management and boards of directors regarding the performance of significant HLF exposures and the organization's overall involvement in this activity.

- Credit standards and pricing policies should be reviewed to determine that they incorporate consideration of the tradeoff between risk and return.

- Each holding company subsidiary should establish appropriate credit review and approval procedures that call for a complete and independent assessment of loans or investments to be made by the subsidiary. Review and approval standards regarding mezzanine financing and equity positions should take account of the particular risks associated with these activities.

- "In-house" limits should be based on consolidated holding company exposure and take account of all extensions of credit, as well as holdings of debt and equity securities issued by HLF obligors. In addition, appropriate exposure limits should also be established for each subsidiary engaged in any aspect of an HLF. When a single HLF transaction involves loans or exposures to legally separate but related obligors, the exposures should be combined for determining compliance with internal exposure limits.

- Examiners should review the banking organization's internal guidelines or practices on what is considered to be an acceptable minimum level of: i) borrower cash flow in relation to debt service and fixed charge requirements; and ii) collateral protection.

- A banking organization's internal credit review and approval procedures should call for an evaluation of the continuity and experience of the borrower's management.

- Examiners should determine that all income, fees and commissions relating to HLFs are properly identified and recognized in accordance with generally accepted accounting principles. Internal reporting systems should monitor the amount and treatment of fees associated with HLFs.

- Examiners should ascertain whether banking organizations purchasing participations in HLFs apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. Examiners should also ensure that the purchasing institution obtains from the lead lender copies of all executed or proposed loan documents, legal opinions, title insurance policies, UCC searches and other relevant documents. The purchase of participations in HLFs originated by other banks should involve a full and independent credit review by the purchasing organization. Organizations holding participations should obtain adequate and timely information on the borrower and closely monitor the borrower's performance throughout the entire life of the exposure.

- Sales of participations in HLFs should be made on a non-recourse basis. Approval procedures and exposure or position limits should apply to any purchases of HLF loans as part of trading or market-making activities. Such purchases should be segregated in a separate trading account and be reported at the current market value, or the lower of cost or market value.

- A banking organization's policies and procedures should provide for legal review of involvement in HLFs to determine that the activities are consistent with applicable laws and regulations and that they are conducted in a manner that addresses the potential for conflicts of interest. Policies and procedures regarding loans to borrowers whose obligations are being underwritten by an affiliated securities firm should be carefully reviewed to determine compliance with the prudential framework set forth in the Board's Section 20 orders. Among other things, this framework requires the banking organization to establish appropriate limits for the consolidated holding company's overall exposure to any single underwriting client of a securities affiliate. Policies should also address the risks associated with equitable subordination. Examiners should determine whether the banking organization has a comprehensive documentation policy addressing the primary legal risk of fraudulent conveyance in LBO transactions.

- Major policies and procedures, including internal credit review and approval procedures and "in-house" exposure limits, should be reviewed periodically and approved by the board of directors.

Other examination considerations

- In evaluating individual loans and credit files, particular attention should be addressed to i) the overall performance and profitability of the industry over time, including during periods of economic or financial adversity; ii) the history and stability of the borrower's market share, earnings and cash flow, particularly over the most recent business cycle and the last economic downturn; iii) the reasonableness of earnings and cash flow projections; iv) the relationship between the borrowing company's projected cash flow and debt service requirements and the resulting margin of debt service coverage; and v) the reliability and stability of collateral values, including their sensitivity to varying economic scenarios, and the adequacy of collateral coverage.

- Particular attention should be paid to the adequacy of a borrower's cash flow. Banking organizations should make an independent and realistic assessment of the borrower's cash flow projections under varying economic and interest rate assumptions and be able to demonstrate that they have taken into account the potential effects of an economic downturn on a borrower's cash flow and collateral values before becoming involved in an HLF.

- A loan whose repayment is not predicated upon an identifiable and historically stable source of cash flow bears speculative qualities. Reliance for loan repayment on the sale of assets or subsidiaries whose values are not clearly supported by i) an historically demonstrated ability to produce adequate cash flow, ii) a firm sales contract or "take-out" commitment, or iii) a realistic cash-generating capacity based upon current economic conditions, is an inappropriate banking practice that could expose a bank to undue risks. Such loans should receive careful supervisory scrutiny and, under normal circumstances, should be subject to examiner comment or criticism. Ordinarily, unless conservatively projected cash inflows provide a reasonable margin above the total debt service requirements and other fixed expenditures of the borrower, classification of the credit is appropriate.

- When the proceeds of asset sales play an important role in reducing the debt, the methods used to determine asset valuations and projected sale proceeds should be carefully scrutinized. In addition, asset collateral coverage should be reassessed periodically throughout the life of the debt, and actual sales proceeds should be compared to projections made at origination of the HLF in order to monitor the reasonableness of the lender's assumptions concerning valuations.

- Repayment programs should specify the sources and timing of repayment, and any significant deviations from the programs should be evaluated.

- The amount of senior debt in relation to total financing should be carefully reviewed. In general, a bank's risk can be reduced if its position is senior to all other levels of debt and secured by a first lien on assets or all the stock of the borrower's operating entities. Ideally, the debt structure should permit the borrower to suspend payments on junior debt should circumstances so warrant.

- Special attention should be given to the risks associated with short-term bridge financing in connection with highly-leveraged restructurings. Such risks may be greater than normal because these loans are typically subordinated to other debt, may not be collateralized, and depend on the successful marketing of longer term securities or the sale of assets for repayment.

- Because of potential conflicts of interest that may affect lending practices, examiners should carefully review any loans and related documentation involving borrowers whose obligations are being underwritten by a securities affiliate.

- Examiners should determine the extent to which borrowers are protected from interest rate increases via interest rate caps or other hedging mechanisms. Generally, long-term loans to HLF obligors should involve some measure of protection for the borrower against increases in interest rates.

- In addition to reviewing the total volume of a banking organization's HLFs, examiners should assess the extent to which the organization's income comprises fees and commissions relating to HLFs. Examiners should also take account of the extent to which income is composed of gains on the sale of equity holdings.

- In addition to equity positions relating to particular HLFs, examiners should determine the extent of the banking organization's involvement in LBO funds.

- Examiners should review the timeliness and quality of reports to senior management and directors. Reports should address the performance of HLF obligors, the quality of the HLF portfolio, and the condition of the organization's overall HLF activities.

- Total HLF exposure should be treated as a potential concentration of credit and if, in the aggregate, it is sufficiently large in relation to capital, the total HLF exposure and a listing of the major HLF obligors should be included on the concentrations page in the examination report. A brief comment should describe the composition of these exposures (i.e., breakdown by number, outstandings, unused commitments, industry involvement, type and level of total criticized).

- If HLFs are not considered to be a concentration of credit, but are still considered a significant activity, the total exposure and the other information described in the previous item should be set forth in the confidential section of the examination or inspection report.

Vice Chairman Johnson subsequently submitted the following in response to written questions from Senator Jake Garn in connection with the hearing held on October 25, 1989:

Question 1: Are you concerned that there may be an over concentration of real estate lending in some sections of the country? Where are these concerns most aggravated? Do you believe that over concentration in any one economic segment creates risks for our financial institutions? Do you believe that it was a mistake to impose a 70 percent QTL test on thrift institutions? Do you believe that the QTL test will make it more expensive to resolve the problems in the thrift industry?

Answer: Excessive construction and real estate lending have shown to be problems in some parts of the United States. In recent years, real estate problems in Texas, Arizona, and other parts of the Southwest have presented significant problems for many financial institutions, leading to substantial loan losses and, indeed, failures of bank and thrift institutions. More recently, real estate lending has produced losses for some banking organizations in the Northeast. Weaknesses are also appearing in some parts of the Southeast.

Adequate diversification is essential to the safe operation of a financial institution. Such diversification requires not only spreading exposure among a range of industries, but also diversifying one's exposure geographically and away from other types of common risks. As we saw during the mid-1980s, major problems in the agricultural and energy markets, for example, caused severe problems to businesses that were only indirectly related to these economic sectors. The ripples caused by lower energy and crop prices caused problems for entire sectors of the country.

Whether it was a mistake or not to impose the QTL provisions of FIRREA depends upon a number of considerations. On the one hand, the test encourages thrifts to concentrate on their traditional function of providing housing finance and, in this regard, may limit their ability to engage in more risky nontraditional activities. On the other hand, by requiring thrifts to concentrate in the mortgage lending business, such limitations will tend to make thrifts more vulnerable to interest rate risk unless they take steps, through use of variable rate mortgages or other means, to minimize such exposure. Moreover, while it is entirely the prerogative of the Congress to seek to subsidize or encourage certain activities, such as home ownership and financing, it is not clear that the QTL test is the most efficient way, from an economic or financial standpoint, to achieve this objective. To the extent the QTL requirement reduces the attractiveness of some thrifts to investors, it would also increase the initial costs of resolving the thrift problem, at least somewhat.

Question 2: Many of the problems in the thrift industry may be traced to excessive powers granted these institutions by the States, starting in 1980. However, unlike recent proposals in the Senate to pass comprehensive powers legislation for holding companies, the States permitted the institution to engage in the new activities directly. Do you believe that Congress should provide banking institutions with new powers? In what areas would you recommend legislation? What structural safeguards would you propose to safeguard the deposit insurance system from the risks that might be presented by new products and services?

Answer: Decisions to expand the powers of financial institutions that have the protection of the federal safety net should be taken cautiously and with proper consideration to many factors, including these: (1) the risks inherent in the activities considered; (2) the additional risks those activities may present to financial institutions by altering the judgments of those institutions regarding the provision of credit; (3) the potential benefits to society and the economy of permitting banking institutions to conduct the activity; (4) the ability of organizations to manage the activity efficiently in a safe and sound manner; and (5) the effects of expanded powers on competition. Given the increasingly international scope of financial markets and the different powers banks have abroad, it is essential that the Congress and the regulatory agencies address the question of bank powers periodically and be prepared to change their laws and regulations.

Currently, the Board supports expanding the securities underwriting activities of U.S. banking organizations by permitting them to conduct a broader range of activities within the United States. Removing the constraints imposed by the Glass-Steagall Act would improve the competitiveness of U.S. bank holding companies in world markets and should provide their customers with a broader and more efficient range of financial services. Moreover, when properly managed and controlled, these activities should not present undue risks to the banking institutions or to society, at large.

There are, however, certain safeguards the Congress should adopt when expanding banking powers that would help to insulate the insured bank from any additional risks associated with the new activity. This can be done by placing the nonbank activities in subsidiaries of bank holding companies, not within an insured bank or within subsidiaries of an insured bank. Proper constraints or "firewalls" must also be imposed to prevent or restrict transactions between an affiliated bank and the nonbank activity.

Question 3: One of the basic principles behind the recently enacted savings and loan legislation was that the deposit insurance function and chartering function should not be contained in the same agency. However, a potential conflict also exists between the insurance function and regulatory function, since it is to a regulator's advantage to have as many institutions as possible within its jurisdiction. Do you agree that a potential conflict exists between the insurance and regulatory functions? Would you recommend that the FDIC's regulatory functions be split off from its insurance functions, so that it becomes a pure insurance agency?

Answer: To the extent any conflicts exist between the insurance and regulatory functions, they seem to be far less than those that existed in the former Federal Home Loan Bank Board, which had the responsibility both to insure and promote the thrift industry. The potential conflict noted in the question between insurance and regulation in one agency would seem to be offset by the agency's desire to avoid weak regulation that could lead to excessive failures and a depletion of the insurance fund.

Question 4: Do you believe the examination force of your agency is sufficient to closely monitor the conditions of banks within your primary jurisdiction? What percentage of such institutions are examined on a yearly basis? On a bi-yearly basis? Less frequently? Do you believe it would be prudent to increase the frequency of bank examinations?

Answer: The Federal Reserve's policy on examination frequency was changed in October 1985 in order to help prevent the development of problems at banking institutions and to make more effective the Federal Reserve's ability to identify and resolve supervisory problems. The Federal Reserve Banks have responded to the intensified examination requirements initiated in 1985, in part, by increasing the number of examiners from 820 in 1984 to 975 as of June 1989.

The sufficiency of examiner resources necessary to effectively supervise banks is accorded significant attention and is subject to continuing review. Given the recent increases in the examiner population, the Reserve Banks generally have a sufficient complement of examiner resources to meet examination frequency and scope requirements; however, their resources have been severely strained in recent years by various ad hoc supervisory assignments, particularly the need to conduct examinations of troubled thrift institutions which are not ordinarily subject to Federal Reserve examinations. As a consequence, special attention is paid to balancing the need for additional increases in staff necessary to meet ad hoc examination requirements with the ever present need to control budgetary increases.

The Federal Reserve's examination frequency policy requires that banking organizations for which the Federal Reserve is primary supervisor be examined at least annually, with the largest organizations and those with significant problems being examined semiannually. Specifically, the policy requires all state member banks to be examined annually by the Federal Reserve or the respective state banking department; problem state member banks and selected others are examined on a semiannual basis. Concerted efforts are made to closely coordinate examinations with the states. Currently, 28 states have entered into "alternate-year" examination programs with the Federal Reserve.

With only a few exceptions, all state member banks have been examined at least annually since 1986. For example, all 1,063 state member banks operating at the end of 1988 were examined at least once during the year. The Federal Reserve conducted 875 examinations either alone or jointly with the state, and the states examined an additional 344 banks independently. The total of 1,219 examinations indicates that approximately 156 state member banks were examined more than once during the year.

Question 5: How much of U.S. banks' improved profitability in 1988 was due to traditional banking activities, as opposed to profits from other new activities?

Answer: The answer to this question is complicated by the lack of a formal definition or consensus on what constitutes traditional banking activities and the fact that banks do not report a consistent and detailed breakdown of their profits by activity. We can, however, state that the increased earnings from activities that produce noninterest income, such as trading activities, fees, and commissions had relatively little overall effect on the improved profitability measures of major bank holding companies during 1988.

Many of the "new activities" conducted by U.S. banking organizations relate to increased securities activities traditionally associated with merchant or investment banks. With respect to U.S. banking, these activities are concentrated among the very largest institutions. It is clear that the dramatic improvement in the profitability of these companies during 1988 is attributable in the first instance to sharply lower provisions for loan losses and, secondly, to wider net interest margins. For the 25 largest bank holding companies, for example, higher noninterest income explains on average only about 4 of the 145 basis point increase shown in their return on assets since 1987. Moreover, the higher noninterest income reported was in large part due to higher service charges on deposit accounts, not to trading activities or to other services these companies provide.

Question 6: Is a larger portion of the typical bank's income now coming from non-interest income sources?

Answer: As a percent of assets, noninterest income of U.S. banks has been increasing for the past decade. That pattern is most pronounced among the largest banks and is much less pronounced among the smallest ones. For example, in 1980 noninterest income (i.e. revenues) equalled 0.60 percent of assets for insured banks with assets less than $300 million and 0.77 percent of the assets of the 25 largest banks. In 1988, these figures were 0.83 percent and 1.92 percent, respectively. Such information for other years and size categories of banks is included on page 71 of the statistics provided to the Committee in preparation for the hearings. These revenues represent mostly commissions and fees on deposit and trust accounts, but include gains from trading foreign exchange and securities, as well.

Question 7: How much of the improvement in the agricultural sector of the economy due to Federal subsidies and how much is due to improvement in the agricultural economy?

Answer: Although government subsidies have played a large role in the improvement of the agricultural economy, several other factors have contributed to a general resurgence of the farm financial outlook. According to USDA statistics, direct government subsidies accounted, on average, for roughly one-third of net farm income in 1986 through 1988. However, subsidies began to decline in 1988, and current USDA projections of net farm income and government subsidies indicate that subsidies should fall to about one-fifth of farm income in 1989. Meanwhile, farm receipts have risen sharply in recent years, reflecting in part stronger demand both domestically and abroad. In addition, farm expenses, after dropping markedly in 1985 and 1986, have risen much less rapidly than sales and for 1989 are projected to be at about the same level as early in the 1980s. Taken together, these trends in farm sales and expenses in recent years have boosted farm income excluding subsidy payments to levels last seen before the recent spell of farm financial difficulties.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

JAMES GILLERAN

Q1. Some people have expressed concern about the growing percentage of real estate loans in bank portfolios. For example, banks in Southern California have extended a substantial amount of real estate credit. How great is this concentration in real estate loans? What impact would a downturn comparable to the downturn in the Texas real estate market have on California banks? Do you believe that concentration in any particular economic segment creates undue risk for depository institutions? Do you have concerns about the requirement in the recently enacted savings and loan legislation that thrift institutions meet a 70% qualified thrift lender (QTL) test?

1: Real Estate loans in the Southern California area have been increasing both in volume and as a percent of the total loans made. The table below gives a breakdown of total loans and real estate loans in the Southern California area since December 1986. As of June 30, 1989, real estate loans totalled $34.4 billion, or 44% of the total loans in the Southern California area. This ratio is higher than the statewide average of 35.6% for state chartered banks and (although not shown), the statewide 41.9% for all California banks.

	LOANS: 12/86		LOANS: 12/87		LOANS: 12/88		LOANS: 6/89	
All Insured Banks	R/E	TOTAL	R/E	TOTAL	R/E	TOTAL	R/E	TOTAL
COUNTY								
San Diego	$ 968	2421	1255	2751	1558	3139	1774	3393
Los Angeles and adjacent counties	$ 19720	65438	21990	64864	27380	69522	32634	74598
Total So. Cal.	$ 20688	67859	23245	67615	28938	72661	34408	77991
Construction	$ 5032		6112		7485		9125	
% of Real Estate to Total	30.49		34.38		39.83		44.12	
% of Construction to Real Estate	24.32		26.29		25.87		26.52	
Single Family	$ N/A		9815		11386		13650	
% of Single Family to Real Estate	-		42.22		39.35		39.67	
California State Chartered only	$ 18290	59500	20170	60700	20940	60600	21590	60800
% of Real Estate to Total	30.74		33.23		34.55		35.51	

Although we are cognizant of the problems caused by a concentration of real estate loans, especially in Texas, we believe the chances of a downturn similar to what happened in Texas occurring here are slim. The economy of California, as a whole, and Southern California in particular are very well diversified and to a certain extent immune to downturns in one particular sector of the economy. The economy of Southern California has industries ranging from aerospace and agriculture to entertainment and tourism.

Secondly, real estate values have never suffered dramatically in the area, and it has been one of the steadiest markets in the country for several years now. Also, the real estate portfolio table above reveals that in the Southern California area, the percentage of construction to total real estate loans has remained fairly stable at around 26%. The statewide figure for state-chartered banks is 38.5%. These figures indicate that the banks in the Southern California area have a much lower concentration of riskier construction lending, and appear to be concentrating on single family dwelling loans. As of June 30, 1989, loans on single family residences made up 40% of the total real estate portfolios in the Southern California area. We believe such loans are not speculative in nature and are supported by strong market values.

On a statewide basis as of June 30, 1989, only 5.1% of state bank real estate loans were delinquent, and only 4.7% of their total loan portfolios were reported delinquent. In Los Angeles and San Diego Counties, 3% of the real estate loans were reported delinquent, and 5.3% of the total loan portfolio.

Delinquent loans have been monitored for years, and we are now in the process of setting up a system to monitor the composition of state bank loan portfolios, not only in Southern California but statewide.

We want to assure you that we are alert to the possible dangers of concentration of assets and will conscientiously monitor the situation.

Q2. What special training, guidance, and experience do your examiners have so that they can effectively supervise state chartered banks' real estate activities?

2: After the law was changed to permit investment in real property, the department convened a task force of senior examiners to develop a work program that would assist in examining such investments. An internal Policy Memorandum 85-3 accompanied the work program and discussed broad issues and policies covering statutory authority, definitions, application process, enforcement actions, accounting practice, and examination procedures. Generally, only senior examiners are assigned to examine such investments.

All examiners attend a series of schools. At the intermediate level, topics include real estate lending, credit practices, and a section on evolving products including asset securitization and direct real estate investment.

Additionally, each banks investment in real property is tracked on a quarterly basis through a special schedule attached to the Report of Condition. Reports are compared to check trends of each bank, and to check whether the bank is within legal limits.

Q3. California has the second most foreign-owned banks in the country. What effect have they had on banking in your state? Are the domestically owned banks able to compete effectively for deposits and loans?

3: At year end 1988, 24 of California's 439 banks were owned by foreign banks. These 24 "subsidiary" banks held assets of approximately $40 billion, or 13.5% of total bank assets. California is also the domicile for 120 branch (agency offices) of foreign banks holding approximately $74 billion in additional assets.

The subsidiary banks perform as local institutions, making consumer and real estate loans to local citizens, offering checking and savings accounts, etc. While it has been alleged that such banks compete unfairly, with lower cost of funds, etc., our figures show that they perform quite similarly to other banks in the state. These institutions are managed by astute bankers, and no doubt are formidable competitors. However, we believe other banks in the state can and do compete effectively. Additionally, these banks have traditionally been good corporate citizens, and provide employment for thousands of local citizens, as well as bringing in new funds into the California marketplace.

The agency offices generally do not compete for deposits, but do compete strongly for loans in the import/export arena. Many of these offices trade heavily on "ethnic" identity, and the ability to do business in a foreign locale.

Q4. In your testimony you stated that the few large state-chartered banks involved in lending to LDCs had set aside adequate reserves for these loans. What percentage of capital do these banks have in LDC lending? What level of reserves have these bank's established?

4: The few banks involved in foreign lending in the state banking system have approximately 50% of their aggregate shareholders equity in LDC lending. We also note that these banks have set aside reserves against these loans in the range of 50% of the LDC loans. The two large banks that account for the bulk of LDC loans have reserves in excess of 50% of their LDC loans.

Q5. Do you have available for use, and do you utilize the call report data base established by the FDIC?

5: The FDIC has extended us the authority to access their call report data base, and we have begun using it extensively beginning September 30, 1989. We also collect additional data from our licensees each quarter about the extent of expanded powers usage.

Q6. There are many ways to authorize new powers for banks. Last year, the Senate passed legislation permitting bank holding companies to form securities affiliates insulated from the bank by "firewalls". Do you believe this is preferable to authorizing new powers for banks directly? Do you believe that similar protection could be afforded if an activity is engaged in by the bank directly so long as the bank has sufficient capital to absorb all possible losses?

6: Placing the authority for new powers in holding company subsidiaries that are affiliated with banks is an effective way of insulating additional risk from the bank. However, it does little to address the situation of several thousand banks that have no holding company. Thought should be given to allowing non holding company banks (typically small community banks) to form subsidiaries for the purpose of conducting expanded powers.

We have found that under proper control,. it is acceptable to place new powers directly within the bank. As noted above, we recommend also allowing banks to form subsidiaries to conduct new powers.

Whether done directly within the bank or in a subsidiary, we believe that any authority for expanded powers should contain provisions for approval (or denial) and close supervision by the appropriate regulator, that the bank should be adequately capitalized, and not be on the "problem" list.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

GERALD LEWIS

Q1. We just finished passing major legislation to provide funds for the resolution of insolvent thrift associations. Many believe that a good deal of the problem in the thrift industry may be traced to over-liberal State legislation, especially laws in such States as Florida, Texas, and California. These states acted as early as 1980 to dramatically increase the powers of their State chartered institutions, at times putting Federally chartered institutions at a competitive disadvantage through their actions. To a large extent the FIRRE Act responded to this problem by giving the FDIC enhanced authority to regulate State granted powers that went beyond the powers authorized for Federal thrift institutions under the National Housing Act and the Garn St Germain Act.

To what extent did your State provide banks with asset powers in the early 1980s comparable to those given to your state thrift institutions? Have there been abuses associated with these powers, and, if not, can you explain why not?

Although many believe a good deal of the problem in the thrift industry may be traced to over-liberal state legislation, we do not consider Florida's investment laws to be "liberal." The situation in Florida is substantially different from that of Texas and California. We find the constant grouping of Florida thrift institutions with Texas and California to be without merit. I have attached a copy of a July 29, 1988, letter and attachments prepared for Mr. William D. Hussey, President of the Florida League of Financial Institutions. As the material indicates, we have found that state and federally chartered institutions have failed in nearly equal proportions around the country. Our research also indicates that investment powers have actually been a net benefit to Florida's state-chartered associations. Service corporation profits provide an important source of capital for Florida's associations, and further protect against losses in the deposit insurance fund.

During the early 1980s, the overriding theme in the banking industry was deregulation of the liability side of the balance sheet. To help off-set the higher cost of deregulation, during 1984 the Florida Legislature granted both commercial banks and savings and loan associations expanded investment powers. The regulations went into effect on October 1, 1984, and allowed either type of institution to invest in the aggregate up to 20 percent of total assets in the stock, obligations, or other securities of subsidiary corporations. Subsidiary investments by commercial banks that have been in existence for less than three years are limited in the aggregate to 10 percent of total assets.

Most of Florida's state-chartered commercial banks have not utilized these investment powers. As of June 30, 1989, 20 percent, or 52, of Florida's 260 state-chartered commercial banks had direct investments in subsidiary corporations. Many of the bank subsidiaries engage in activities that are "closely related to banking" and the investments would be permitted for national banks.

For example, state-chartered banks have invested in subsidiary corporations that engage in mortgage banking, armored car services, leasing of bank premises, data processing, loan administration, real estate appraisal and other financial services. Banks have also invested in real estate related corporations, including joint ventures, real estate development, DPC corporations and other investments involving real property.

Florida's commercial banks have made only limited use of these investment powers and there have only been isolated instances of abuse of this authority. As I indicated in my October 17, 1989, testimony, three of the last eleven state banks that have been closed during the last four years abused or mismanaged investments in corporations associated with ADC lending. Another institution is close to insolvency primarily as a result of this activity. But, as I previously stated, these are isolated instances. The majority of Florida's banks are well-managed and have used their investment powers prudently and profitably.

Q2. State banking regulatory agencies (like Federal banking agencies) often receive funding primarily from examination fees assessed on State chartered institutions. If there is a decline in the number of institutions, the funds available to the State agency declines, while if there is an increase in the number of such institutions, the budgets of the regulatory agencies will grow.

Does this situation lead to a conflict of interest, in that there is an incentive for the banking agency to encourage institutions to seek State charters through more liberal supervision or regulation?

Has this been a problem in the past in your State?

Since the same incentives may well apply at the Federal level, do you feel that a similar problem exists with the Federal banking agencies? If not, why not?

In what ways can State or Federal banking agencies maintain or achieve more independence from the industry they regulate?

Bank regulators, whether state or federal, do not create the demand for bank charters. Demand is simply a function of market forces. Therefore, more liberal supervision and regulation would be largely ineffective in attracting new entrants into the market.

Also, there is no clear relationship between the number of institutions regulated by my office and the budget of the department. Thus, there is no incentive for my office to encourage institutions to seek state charters, particularly through liberal supervision or regulation.

During the last few years, I have tightened the de novo standards and the chartering process for new banks. The banking experience requirement for proposed officers and directors has been increased and we continue to conduct more thorough background checks on each proposed officer, director, and major shareholder. Capital requirements have also been increased. Effective October 1, 1989, the initial capital requirement for new banks was doubled. De novo banks located in metropolitan areas must now raise $4 million prior to opening and banks in other areas must raise $2 million. During the last few years, I have denied an increased number of de novo bank applications and many applications have been withdrawn because of difficulties in meeting the stiffer requirements. It is interesting to note that since our chartering process has become more restrictive, several applications that I denied have been subsequently approved for a national charter by the Office of the Comptroller of the Currency.

Also, it is our experience in Florida that newly chartered and problem institutions cost more to regulate than the assessments we receive from these institutions. Every incentive exists to ensure that the financial institutions we charter make economic sense within the marketplace. New and established banks must be directed and managed by capable and knowledgeable individuals. Chartering institutions that do not meet these criteria create regulatory costs far in excess of the assessments they generate.

The federal regulatory environment is also too complex to state that a bias toward liberal supervision and regulation exists due to the necessity to receive adequate funding. Checks and balances are in place to preclude state or federal regulators from engaging in lax supervision and regulation. Also, federal and state regulatory agencies must receive executive and legislative budgetary approval--approvals that in large part bear little relationship to institutional assessment levels. The recognized inadequate funding of the FHLBB, for instance, was much more a function of Congress' reluctance to fund the agency than an inadequate assessment base.

Q3. One of the more significant issues raised in the savings and loan debate concerned capital standards, and the appropriate level of capital for thrift institutions. Following the passage

of the legislation, a debate broke out among Federal regulators as to the appropriate level of capital that should be required of banks.

Do you believe that the banking industry is sufficiently capitalized?

Do you favor increasing or decreasing capital levels?

Do you agree with the position that a 6 percent non-risk adjusted capital requirement should still be mandated after the risk-adjusted capital standards go into effect?

Although there are individual exceptions, I believe the Florida banking industry has an adequate level of capital to protect the deposit insurance fund. I do not favor decreased capital standards for Florida's commercial banks and, in fact, would not be opposed to slightly higher capital standards industry-wide. I also do not take issue with the 3 percent leveraged capital ratio as proposed by the Office of the Comptroller of the Currency and the Federal Reserve Board.

Perhaps recent discussions and controversies concerning the adequacy of capital have been too academic. In reality, no banking regulator can force stockholders, management or others to recapitalize a problem bank. No absolute amount of capital will ever be sufficient for all institutions. The risk-based capital standards go a long way to address this fact, and that is why I have supported the risk-based concept since inception.

Market discipline and ultimately protection of the deposit insurance fund may be more appropriately addressed by initiating risk-adjusted insurance premiums, rather than higher capital levels. Institutions that pose the least threat should not have to subsidize the risk-taking activities of their competitors. Risk-adjusted premiums would appropriately penalize those institutions that pose the greatest threat to the insurance fund by forcing those institutions to pay a higher proportion of their profits into the insurance reserve.

Q4. Some States have recently received the authority to engage in real estate investment and development either directly or through a subsidiary. Do you permit banks in your state to engage in these activities? If so, what was the policy justification for this authorization? Do you have concerns about these powers? Are you aware of other states which have taken similar action?

Since 1984, the Florida banking statutes have authorized state-chartered commercial banks to invest in the aggregate a maximum of 20 percent of their assets in subsidiary corporations or other corporations. Subsidiary investments by banks in existence for less than three years are limited in the aggregate to 10 percent of total assets. These subsidiary investments could include investments in companies engaged in real estate and development. As previously indicated, Florida banks have made limited use of this power and less than 9 percent of the banks have investments in corporations that engage in real estate activities.

A Florida-chartered savings and loan association can invest an amount not exceeding the lesser of its net worth or 10 percent of its assets in the purchase of real estate for income production purposes. Florida-chartered commercial banks do not have the same direct investment privileges, but can share in the profits, earnings or income of a business enterprise. This authority was granted to state-chartered banks in 1981 under statutory provisions that allow state-chartered financial institutions to operate under competitive conditions with federally chartered institutions. State-chartered commercial banks may also invest in real estate investment companies under the statutes governing investments in subsidiary operations.

The policy decision for allowing expanded investment powers was based on a number of factors, including:

-- Congress began to deregulate the banking industry in the 1980s. Deregulation was the name of the game throughout the 1980s and expanded powers seemed to be in line with Congressional intentions.

-- Institutions clearly needed new vehicles for profit making, diversification of risk, and interest rate risk reduction.

-- Florida institutions needed to be able to compete with out-of-state institutions that were doing business in the state.

-- Regarding direct equity participations, state banks were given this authority through the competitive equality banking statute after the Office of the Comptroller permitted national banks to engage in this activity.

Florida is not alone in allowing commercial banks to invest in real estate subsidiaries. According to the attached March 1989 survey conducted by the Conference of State Bank Supervisors, entitled "State Authorization of Selected Expanded Activities for State Chartered Banks," 23 states allow state-chartered commercial banks to engage in real estate development. The majority of the states report minimal activity by their commercial banks.

Q5. What securities underwriting, real estate investment and development and insurance powers are banks in your state allowed to engage in and how are those powers regulated, i.e. by quantitative limitations, firewalls or other regulatory restrictions, separate affiliate requirements, capital requirements, etc?

What is the extent of the activity undertaken under these permitted powers by your state's banks? For example, are state banks required to submit a request to enter into specific securities, real estate or insurance activities or a proposed plan prior to commencing such activities to the state bank regulator prior to approval?

State-chartered banks in Florida are prohibited from engaging in insurance underwriting or brokerage, except in the case of credit life insurance brokerage. Banks may not engage in securities underwriting, but they are permitted to engage in securities brokerage through a subsidiary corporation. As previously indicated, commercial banks may also directly and indirectly participate in real estate related activities.

Commercial banks in Florida have made limited use of their investment powers. Less than 9 percent, or 23, of the state's 260 state-chartered commercial banks have invested in real estate investment or development companies.

Although banks are not required to seek approval from my office before investing in a subsidiary corporation, all state-chartered banks are required to submit quarterly financial and other operating data on each subsidiary corporation.

Q6. What effort is your State making to detect bank fraud, prosecute criminal misconduct, and prevent unsuitable persons from entering the banking industry as owners, directors, or managers?

My office has initiated several methods for identifying and prosecuting white collar crime. We communicate daily with state and federal law enforcement and bank regulatory agencies about potential white collar criminals and other bank insiders. When warranted, we contact regulators in other state banking departments and we participate in quarterly Interagency Supervisory Conferences with the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the Federal Bureau of Investigation. During these workshops, the participants have the opportunity to share common supervisory problems.

We have expended a substantial amount of effort to identify problem borrowers in Florida's financial institutions. We have other available information concerning individuals and corporations that have engaged or want to engage in fiduciary activities in the State of Florida. This information, together with our currency transaction data base, provides us with a wealth of data to help identify criminal misconduct and potentially unsuitable insiders.

My office contains a separate investigative unit with trained investigative specialists who work closely with state and federal law enforcement agencies on suspected white collar crimes. We have participated in the investigation and prosecution of numerous individuals who have defrauded Florida's financial institutions. For example, my staff was largely responsible for the successful prosecution and imprisonment of an executive officer and another insider in the failed Sunrise Savings and Loan Association. On December 15, 1989, a former official at the failed Trust Bank will be sentenced for adjudication of guilt in connection with that bank's failure. We have also been the focal point in numerous other investigations and prosecutions of other while collar criminals.

The investigative section also performs thorough background checks on individuals proposing to establish a de novo institution or acquire an established financial institution. Also, the investigative staff works closely with the bank and savings and loan examination staff to investigate possible wrongdoing. Both our examiners and investigators are given training on white collar crime. For example, the examiners attend various Federal Deposit Insurance Corporation (FDIC) and Federal Financial Institution Examination Council (FFIEC) schools on this subject. In addition, every examiner and investigator attended a two-day, in-house training program on white collar crime and insider abuse earlier this year.

Q7. Have recapitalizations of troubled banks been successful in your State? If not, why not?

Recent recapitalization efforts of commercial banks have been very successful. This year, two imminently insolvent commercial banks were recapitalized with outside funds, at no cost to the deposit insurance fund and with no loss of depositor funds. Currently, there is one promising prospect for recapitalization.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

GERALD LEWIS

Q1. What limits are placed on the real estate equity participation in real estate development activities of state-chartered banks? How many banks fully utilize these powers? Have these real estate powers caused the failure (or near failure) of any Florida banks?

During 1981, I issued an Order of General Application (OGA) authorizing state-chartered banks to share in the profit, income or earnings from a business enterprise of a borrower. This OGA was issued pursuant to Florida's competitive equality banking statute which allows Florida financial institutions to operate on an equal basis with nationally chartered banks.

Like national banks, there are no specific limitations on the aggregate amount of equity participation activities for state-chartered banks. But, such limitations do little to protect a bank from losses on this type of activity. What is essential is the establishment and maintenance of sound, responsible underwriting standards.

In Florida, a very limited number of banks have become active in profit participation lending. The exact number of banks involved in this type of lending is not known, since reports filed with both state and federal regulatory agencies currently do not specifically identify this activity.

Although the number is small, several banks have recently experienced problems with equity participation loans. But, no state-chartered bank in Florida has ever failed as a direct result of equity participation loans. Failed banks with equity participation loans on their books, and other banks experiencing problems with these types of loans, have not had problems as a direct result of taking an equity position in a real estate project. Rather, the problems developed as a result of poor or non-existent underwriting standards. Also, these loans are generally not originated as equity participations. Instead, banks usually take an equity position in a real estate project to protect their interest on problem or non-performing real estate loans.

Q2. How many Florida banks have become active in securities underwriting? What type of investments have Florida banks underwritten?

State-chartered banks in Florida are specifically prohibited from underwriting securities.

Q3. Have these expanded bank powers lead to an increase in the number of state-chartered banks in Florida?

During the early 1980s, the overriding theme in the banking industry was deregulation of the liability side of the balance sheet. To help off-set the higher cost of deregulation, during 1984 the Florida Legislature granted both commercial banks and savings and loan associations expanded investment powers. The regulations went into effect on October 1, 1984, and allowed either type of institution to invest in the aggregate up to 20 percent of total assets in the stock, obligations, or other securities of subsidiary corporations. Subsidiary investments by commercial banks that have been in existence for less than three years are limited in the aggregate to 10 percent of total assets.

It is difficult to pinpoint why bank management decides to become state-chartered or nationally-chartered. My sense is that the powers issue is mostly a non-issue in Florida. Most of Florida's state-chartered commercial banks have not utilized these investment powers. As of June 30, 1989, 20 percent, or 52, of Florida's 260 state-chartered commercial banks had direct investments in subsidiary corporations. Many of the bank subsidiaries engage in activities that are "closely related to banking" and the investments would be permitted for national banks.

There is no correlation between expanded investment powers and the number of state-chartered banks. Since 1984, when commercial banks were first given expanded investment powers, the number of state-chartered commercial banks has actually declined slightly. During 1984, Florida had 256 state-chartered commercial banks. At the end of 1988, state-chartered banks in Florida numbered 251.

During this same time, however, the number of de novo (new) bank applications increased as follows:

1980	8
1981	10
1982	13
1983	28
1984	25
1985	23
1986	38
1987	40
1988	16
1989 (YTD)	5

As can be seen, interest in commercial bank charters increased before the enactment of Florida's expanded investment legislation, and continued to increase after 1984. Much of this de novo activity can be attributed to Florida's interstate banking legislation (effective July 1, 1985) and the associated increased value of Florida bank charters. I might add that the Office of the Comptroller of the Currency experienced a similar increase in applications for nationally chartered Florida banks.

The Florida banking market has always been attractive to out-of-state banking organizations. During the mid-1980s, many interstate banking transactions took place and many out-of-state institutions were identifying potential acquisitions in Florida. This increased interest in bank charters drove the price of Florida bank stock up to two and three times book value, making bank charters a more attractive investment.

During the last few years, I have tightened the de novo standards and the chartering process for new banks. The banking experience requirement for proposed officers and directors has been increased and we continue to conduct more thorough background checks on each proposed officer, director, and major shareholder. Capital requirements have also been increased. Effective October 1, 1989, the initial capital requirement for new banks was doubled. De novo banks located in metropolitan areas must now raise $4 million prior to opening and banks in other areas must raise $2 million. During the last few years, I have denied an increased number of de novo bank applications and many applications have been withdrawn because of difficulties in meeting the stiffer requirements. It is interesting to note that since our chartering process has become more restrictive, several applications that I denied have been subsequently approved for a national charter by the Office of the Comptroller of the Currency.

Q4. In your testimony you were critical of the failure of FSLIC to close Freedom Savings and Loan. What was your independent authority to place Freedom in receivership and why wasn't this authority exercised?

At the time of Freedom's insolvency, I had the independent authority to close any insolvent institution. Once declared insolvent, by law the association had to be turned over to a receiver. Florida Statutes specifically identified the Federal Savings and Loan Insurance Corporation (FSLIC) as the receiver of federally insured savings associations. The statutes were silent on appointment of a receiver other than the FSLIC for insured institutions. At the time of Freedom's insolvency, the FSLIC did not have the resources to accommodate my request for receivership. Therefore, although I had the independent authority to close Freedom as soon as it reached insolvency, in reality the institution could not be closed until the FSLIC had the human and financial resources to act as receiver.

The 1989 Florida Legislature amended this section to allow the department to appoint another receiver if the insurer declines to accept the appointment. But, as a practical matter, the appointment of another receiver may not be realistic since the insurer is ultimately at risk and few others, if any, have the resources to properly handle a failed institution.

Q5. To what extent was the failure of FSLIC to take more timely action the result of lack of funds available to FSLIC? Did your office support refunding FSLIC in 1986 and 1987? Did you communicate your views on FSLIC re-funding to the Congress?

I believe the FSLIC's failure to promptly take action on insolvent Florida institutions was directly the result of a lack of human and financial resources. In other words, the lack of adequate funding precluded the FSLIC from taking more timely action on resolving Florida's insolvent savings and loan associations.

My office strongly supported the refunding of the FSLIC. During 1987, I made two trips to Washington, D.C. and communicated this support. During these trips, I met with Florida's representatives in the House and Senate, as well as the Chairmen of the FDIC and FSLIC. My office also periodically communicated with Congressional representatives and various banking regulators and supported the work of trade organizations like the Conference of State Bank Supervisors, the Florida Bankers Association and the Florida League of Financial Institutions.

Q6. To what extent did liberal State powers contribute to the failure of Freedom and other State institutions? When were Florida thrifts given additional powers not available to Federal institutions and what was the rationale for this decision? To what extent did the failure of State authorities to monitor these powers contribute to the problems at Freedom and other Florida institutions?

Freedom did not fail as a result of expanded powers. Freedom failed the old-fashioned way; it was simply unable to profitably operate in the face of deregulation.

In 1980, Freedom was a reasonably healthy federally chartered savings and loan association. Freedom converted to state charter in May 1980, at the same time Congress began to deregulate the banking industry. By 1982, Freedom began to experience operating losses. As the cost of funds increased, the association's net interest margin was narrowed. High interest rates, combined with a slow-down in the Florida real estate market, continued to cause operating losses at Freedom, as well as other thrifts around the country. During 1983, insider abuse and fraudulent activity contributed to further losses at Freedom and the association came under closer scrutiny of state and federal regulators. [It wasn't until this time (1984) that Florida first permitted state-chartered savings associations to invest up to 20 percent of their assets in service corporations.] As operating losses continued to mount, Freedom began to relax its underwriting standards, which caused substantial losses on several major loans and investments. The classic cycle of operating losses, lower net interest margins, higher risk investments, more operating losses, etc. was evident at Freedom. Options for recapitalizing Freedom were quickly diminished and by July 1986, Freedom Savings and Loan Association was insolvent.

Freedom did not fail as a result of expanded powers. Only one association, Sunrise Savings and Loan Association, failed in Florida as a direct result of abuses of investment powers. Sunrise has since been the subject of several Congressional investigations.

Florida thrift institutions were given expanded investment authority in 1984. The policy decision for allowing expanded investment powers was based on a number of factors, including:

-- Congress began to deregulate the banking industry in the 1980s. Deregulation was the name of the game throughout the 1980s and expanded powers seemed to be in line with Congressional intentions.

-- Institutions clearly needed new vehicles for profit making, diversification of risk, and interest rate risk reduction.

-- Florida institutions needed to be able to compete with out-of-state institutions that were doing business in the state.

The state did not fail in its responsibility to regulate investment powers of state-chartered financial institutions. In fact, during the 1980s, Florida had a cooperative arrangement with the Federal Home Loan Bank of Atlanta (FHLBA). My office and the FHLBA conducted joint examinations of all state-chartered savings and loan associations in Florida. Therefore, my office and the FHLBA shared the responsibility for monitoring and supervising the state-chartered thrifts in this state.

Q7. There are many ways to authorize new powers for banks. Last year, the Senate passed legislation permitting bank holding companies to form securities affiliates insulated from the bank

by "firewalls." Do you believe this is preferable to authorizing new powers for banks directly? Do you believe that similar protection could be afforded if an activity is engaged in by the bank directly so long as the bank has sufficient capital to absorb all possible losses?

In authorizing new powers for financial institutions, Congress should look at the business dynamics of each activity individually and determine the ultimate effect on capital levels. The nature of each activity, and the potential risk to the institution, should be the key considerations in allowing powers directly or indirectly. For example, activities that allow the institution to act in an agency function are probably more appropriate for direct investment. Other activities that may pose more direct risk to the institution are perhaps more appropriate if the bank is protected by firewalls.

An institution may never have "sufficient" capital to absorb all possible losses associated with certain business undertakings. Certain business dynamics inherently have more risk than can be absorbed by institutional capital alone. It is precisely for this reason that businesses acquire liability insurance and other insurance coverage to hedge the risks that cannot possibly be absorbed through capital.

Q8. Some people have expressed concern about the growing percentage of real estate loans in bank portfolios. Do you believe that concentration in any particular economic segment creates undue risk for depository institutions? Do you have concerns about the requirement in the recently enacted savings and loan legislation that thrift institutions meet a 70% qualified thrift lender (QTL) test?

Sound banking practices suggest that concentration in any asset or liability portfolio is not prudent. The old theory of "don't put all of your eggs in one basket" applies to an institution's asset portfolio, as well as its liabilities. Therefore, excessive concentration in real estate or any other economic segment is generally unsafe.

I do have concerns with the QTL requirement, but not because of traditional concerns with concentrations of credit. The QTL test allows for some diversification in real estate lending, but the emphasis will be on more single-family home lending. Single-family housing loans traditionally carry lower risk and lower returns than commercial real estate transactions. I believe the lower returns associated with QTL qualifying loans could be the beginning of a repeat of the early 1980s.

Lower-risk assets mean lower returns, and interest rate margins may again be reduced. Thrift associations in compliance with the QTL may not be able to meet asset/liability policies, profitability may decline, and bottom line capital may be eroded further. In looking for new sources of income, and ultimately capital, thrifts in compliance may be forced to take on even more risky investments to offset the QTL portion of the association's portfolio.

Thrifts that are not in compliance will eventually have to convert to commercial bank charters to remain profitable. Ultimately, the QTL may severely reduce the viability of the thrift industry in the United States.

Questions for Howard B. Brown

RESPONSES TO QUESTIONS FROM SENATOR DONALD W. RIEGLE, JR.

Q1. We just finished passing major legislation to provide funds for the resolution of insolvent thrift associations. Many believe that a good deal of the problem in the thrift industry may be traced to over-liberal State legislation, especially laws in such States as Florida, Texas and California. These States acted as early as 1980 to dramatically increase the powers of their State chartered institutions, at times putting Federally chartered institutions at a competitive disadvantage through their actions. To a large extent the FIRRE Act responded to this problem by giving the FDIC enhanced authority to regulate State granted powers that went beyond the powers authorized for Federal thrift institutions under the National Housing Act and the Garn St Germain Act.

– To what extent did your State provide state banks with asset powers in the early 1980s comparable to those given to your state thrift institutions? Have there been abuses associated with these powers, and if not, can you explain why not?

1. Prior to 1985, the investment powers of state bank and trust companies, savings banks and savings and loan associations varied in several important respects. State bank and trust companies were not subject to the asset limitations that applied to savings banks and savings and loan associations on investments in commercial, personal and educational loans, and leases of personal property. However, savings banks and savings and loan associations had broader powers than did state bank and trust companies to invest in investment securities. Public Act No. 85-379, "An Act Concerning Banking Powers", established parity between the banking institutions of Connecticut, excluding credit unions, for major banking powers and granted equivalent powers to state chartered institutions as those then available to federally chartered institutions. The Act clarified that a state bank and trust company had the same authority as a savings bank or a savings and loan association to invest in investment securities, either debt or equity. It granted state bank and trust companies the authority which savings and loan associations had to invest up to 8% of assets in any prudent investment whether or not the investment fell into a specific statutory investment category. There have not been any apparent unreasonable abuses associated with these new powers. I think there are a number of reasons for this including relatively conservative management, sound business decisions, and effective regulatory and examination oversight.

Q2. State banking regulatory agencies (like Federal banking agencies) often receive funding primarily from examination fees assessed on State chartered institutions. If there is a decline in the number of such institutions, the funds available to the State agency declines, while if there is an increase in the number of such institutions, the budgets of the regulatory agencies will grow.

– Does this situation lead to a conflict of interest, in that there is an incentive for the banking agency to encourage institutions to seek State charters through more liberal supervision or regulation?

– Has this been a problem in the past in your State?

– Since the same incentives may well apply at the Federal level, do you feel that a similar problem exists with the Federal banking agencies? If not, why not?

– In what ways can State or Federal banking agencies maintain or achieve more independence from the industry they regulate?

2. It should be noted that new groups of organizers seek us and although we encourage the formation of state chartered institutions, we offer no special incentive to do so. The most common mentioned reasons for opting for a state charter are familiarity with the system and accessibility to the primary regulator. As a matter of fact, our capital requirements are generally more stringent than under the federal system and several recently chartered federal institutions reportedly decided against state charters because of this factor. Furthermore, our supervisory and examination procedures are consistent with federal standards. This has not been a problem in regard to state chartered institutions but I cannot speak for my federal counterparts. In my opinion, banking agencies must balance their roles as regulators, supporters, and advocates in order to effectively fulfill their mission. This has not been a problem for this agency nor, as far as I can determine, for most of the other state and federal banking regulators with whom I deal.

Q3. One of the more significant issues raised in the savings and loan debate concerned capital standards, and the appropriate level of capital for thrift institutions. Following the passage of the legislation, a debate broke out among the Federal regulators as to the appropriate level of capital that should be required of banks.

– Do you believe that the banking industry is sufficiently capitalized?

– Do you favor increasing or decreasing capital levels?

– Do you agree with the position that a 6% non-risk adjusted capital requirement should still be mandated after the risk-adjusted capital standards go into effect?

3. I feel that Connecticut state chartered banks and thrifts are adequately capitalized. That is not to say however, that I would discourage the formation of additional capital. Other state and federal regulators must assess their own situations. I don't think this is the appropriate time to lower minimum capital levels however, I am not uncomfortable with the recently announced FRB compromise position on this issue.

Q4. Some States have recently received the authority to engage in real estate investment and development either directly or through a subsidiary. Do you permit banks in your State to engage in these activities? If so, what was the policy justification for this authorization? Do you have concerns about these powers? Are you aware of other States which have taken similar action?

4. Connecticut law allows state-chartered banks to invest up to 5% of their assets in interests in real estate which the bank may acquire by foreclosure or purchase. It also authorizes banks to lease and convey such real estate and to invest their assets in the improvement and development of such real estate. Further, through an interpretive opinion of the Department of Banking, a state-chartered commercial bank may acquire real estate, develop it and sell it, in joint venture with developers, but may not do so for speculation. Connecticut law also permits banks, subject to the approval of the Commissioner, to acquire, hold and convey real estate as may be necessary for the transaction of their business. Banking institutions may also invest their assets in the equity securities of any corporation doing business in the United States; however, twenty-four hours prior written notice is required if the investment is 25% or more of the stock of the acquired corporation. The banking statutes do not restrict the activities engaged in by these acquired institutions, and therefore, a bank could conceivably invest in a subsidiary which engages in real estate investment and development activities. In addition, Connecticut banking institutions are authorized to establish, subject to the approval of the Commissioner, service corporation subsidiaries. Such subsidiaries are limited to engaging in those activities which the bank may engage in directly. Since, as mentioned above, banking institutions are permitted to invest in real estate, their service corporations would be permitted to make similar investments. Institutions have generally used real estate investment and development powers prudently and as long as they continue to do so, I am no more concerned about these activities than others. A number of states have authorized their institutions to undertake similar activities and the problems encountered seem to be related to the degree of prudence exercised by management.

Q5. What securities underwriting, real estate investment and development and insurance powers are banks in your state allowed to engage in and how are those powers regulated, i.e., by quantitative limitations, firewalls or other regulatory restrictions, separate affiliate requirements, capital requirements, etc.?

– What is the extent of the activity undertaken under these permitted powers by your state's banks? For example, how many banks engage in these activities? What is the approximate dollar volume?

– As the state bank regulator do you have a means to monitor which state banks enter into each of these activities? For example, are state banks required to submit a request to enter into specific securities, real estate or insurance activities or a proposed plan prior to commencing such activities to the state bank regulator prior to approval?

5. The Connecticut banking laws are silent with respect to the ability of financial institutions to engage directly in securities underwriting. All such institutions may, as mentioned in my response to Question 4 above, invest 10% of their assets in the equity securities of any U.S. corporation, with written notification to the Banking Commissioner at least twenty-four hours prior to any such investment resulting in the bank having invested in 25% or more of the stock of such a corporation. The authority of Connecticut banks to engage in real estate investment and development is discussed in my response to Question 4 above. With respect to insurance powers, in general, Connecticut law appears to prohibit financial institutions from directly engaging in the business of selling insurance, with certain limited exceptions. These laws allow banks to sell credit life insurance, make a specific exception for savings banks to sell savings bank life insurance, and contain certain grandfather provisions. The banking statutes prohibit any state-chartered commercial bank from engaging in the business of "marine, fire or life insurance, fidelity, surety, accident, health, liability, credit, title or other form of casualty insurance", with certain exceptions. The state savings bank and savings and loan association statutes do not contain any such specific prohibition; however, the state insurance statutes prohibit the Insurance Commissioner from issuing a license to sell fire and casualty insurance, or life and health insurance to any lending institution, bank holding company, subsidiary or affiliate of a lending institution or to an officer or employee of such an entity, with certain grandfather provisions. All banking institutions may lease space to insurance companies under their incidental powers.

   Real estate investment and development activities are regulated by quantitative limitations and safety and soundness considerations. Investments by state-chartered banks in unconsolidated subsidiaries, which are the general vehicles for such investments, represent less than 1% of total assets. Each state chartered institution must either request approval or notify this office of the establishment of subsidiaries and such activities are monitored through the examination process.

Q6. What effort is your State making to detect bank fraud, prosecute criminal misconduct, and prevent unsuitable persons from entering the banking industry as owners, directors or managers?

6. Upon detection of fraud, cases and referred to the State's Attorney Office. State Police checks are completed on all organizers of new banks. Appropriate action is taken to deal with unsuitable owners, directors, and managers as necessary.

Q7. Have recapitalizations of troubled banks been successful in your State? If not, why not?

7. There have not been any recapitalizations of troubled institutions in Connecticut.

Questions for Howard B. Brown from Senator Jake Garn concerning the October 17, 1989 hearing.

Q1. Why did nine of the ten new banks opened in Connecticut in 1988 have state charters?

1. Please refer to item #2 of response to Senator Riegle.

Q2. Some people have expressed concern about the growing percentage of real estate loans in bank portfolios. How great is this concentration in real estate loans in Connecticut? Do you believe that concentration in any particular economic segment creates undue risk for depository institutions? Do you have concerns about the requirement in the recently enacted savings and loan legislation that thrift institutions meet a 70% qualified thrift lender (QTL) test?

2. State chartered commercial banks continue to have a balanced portfolio. As of December 31, 1988, the distribution was 53% real estate loans, 30% commercial loans, 13% consumer loans, and 4% in other miscellaneous categories. 47% of real estate loans are secured by 1-4 family residential properties, a low risk credit. State chartered savings banks, all of which are FDIC (BIF) insured, are traditional mortgage lenders. However, their portfolios are becoming more diversified as they endeavor to broaden their product base. As of December 31, 1988, the distribution of loans was 84% real estate, 8% commercial, 7% consumer, and 1% in miscellaneous categories. 74% of real estate loans are secured by 1-4 family residential properties. Portfolios are adequately diversified and substantially secured. I am not particularly concerned about the 70% qualified thrift lender test. If an institution chooses to operate primarily as a mortgage lender, they should be allowed to do so. Those that choose to become more broad based will have to become more competitive and less reliant on the Federal Home Loan Bank for funding.

Q3. The level of non-performing loans in Connecticut banks increased dramatically in 1988, but the level of loan loss reserves did not keep pace. Why not?

3. The level of non performing loans increased from 1.01% (December 31, 1977) to 1.30% (December 31, 1988) of total loans. On it's face, your statement that the level of loan loss reserves did not keep pace is not inaccurate. However, it should be noted that state chartered commercial banks continue to maintain loan loss reserves in excess of 1% of total loans, and savings banks increased their loan loss reserve to 0.42%, equal to the national average for all FDIC (BIF) insured savings banks. It should also be noted that as of December 31, 1988, the ratio of non performing loans to total loans for state chartered commercial and savings banks was 1.63% and 1.17%, respectively. This is considerably lower than national averages which indicate a non performing average of 1.99% for commercial banks and 1.38% for savings banks. Furthermore, the loan loss reserve for Connecticut state chartered banks represented 46% of total non performing loans. Finally, focusing solely on the level of the loan loss reserve fails to take into consideration the level of capital which is the ultimate indication of an institution's ability to absorb losses. As of year-end 1988, the level of primary capital (defined as equity capital plus loan loss reserve) for all state chartered banks was 8.58%. Even under the worse case scenario, if all non performing loans were to be charged off, which is most improbable, the primary capital level would still be 7.68%.

Q4. What kind of real estate lending have state chartered credit unions begun doing to cause a 47% increase in their outstandings in 1988?

4. The increase in real estate lending by state chartered credit unions is attributed entirely to first and equity loans made to members and secured by liens on their primary residences. The growth in mortgage lending is in response to the changing needs and borrowing preferences of members. State chartered credit unions are not involved in commercial real estate lending. However, as you well know, any such type lending is subject to specific restrictions as specified by the NCUA Business Rule Regulation. Since the deposits of all state chartered credit unions are insured by the NCUA, they would be subject to such regulations in addition to state requirements.

5. I agree with the approach taken by the Senate to allow additional powers to be exercised through subsidiaries in order to insulate the bank from potential liability. Since it is virtually impossible to determine how much bank capital would be sufficient to absorb all possible losses, I think that the undertaking of non-traditional banking type activities should be conducted through subsidiary corporations.

Q5. There are many ways to authorize new powers for banks. Last year, the Senate passed legislation permitting bank holding companies to form securities affiliates insulated from the bank by "firewalls". Do you believe this is preferable to authorizing new powers for banks directly? Do you believe that similar protection could be afforded if an activity is engaged in by the bank directly so long as the bank has sufficient capital to absorb all possible losses?

Responses of

Kenneth W. Littlefield

Banking Commissioner of Texas

to subsequent questions of

Senator Donald W. Riegle, Jr., Chairman

and

Senator Jake Garn

U. S. Senate

Committee on Banking, Housing and Urban Affairs

November 27, 1989

Questions from Senator Donald W. Riegle, Jr.:

Question 1: What asset powers were given to state banks in the early 1980s similar to those enjoyed by state-chartered thrifts? And have there been abuses of such powers?

Response: State banks were given no additional asset powers similar to those granted to thrift institutions. Since Texas banks have no exotic powers, no abuses have occurred. Banking in Texas has throughout the 1970s and continuing through the 1980s been limited to basic commercial banking. No powers such as securities and insurance underwriting or direct real estate investment have been granted to banks regardless of whether they were state or federally chartered. National banks have never been at a competitive disadvantage to state banks in Texas. On the contrary, national banks previously enjoyed some advantages. For example, until recently, state banks were required to post a supersedeas bond once an unfavorable judgement had been rendered. National banks were not required to post such a bond until all appeals had been exhausted and the judgement was final.

Question 2, Part (a): Is a conflict of interest created when regulatory agencies are funded by examination fees collected from the banks they regulate?

Response: In my opinion, no. The Texas Department of Banking receives its funding from assessments and fees charged to the banks based on the institution's total assets. The factor used in calculating the fee is derived from the department's historical operating data and its legislatively approved budget. Our budget is designed to recover estimated costs, and the system of checks and balances established by oversight of the Finance Commission and the Legislative Budget Board provides the necessary independence to preclude the regulatory agency from promoting state charters or the regulated banks from exercising undesirable influence over the agency.

Part (b): Has the potential for a conflict of interest due to the Department's funding mechanism been a problem in the past?

Response: No. As mentioned above, the Department is sufficiently insulated from the banks under its jurisdiction to preclude undesirable influence in either direction. The Department also works closely and communicates very freely with the Comptroller of the Currency to preclude banks from making charter conversions or "charter shopping" to escape regulatory sanctions.

Part (c): Since the funding mechanism for federal bank regulatory agencies is similarly based on fees collected from banks, does a conflict of interest exist there?

Response: No, I do not believe so. The federal methodology for assessing and collecting fees is similar to that used by the State of Texas except that the OCC and FDIC do not collect an examination fee. Expenditures are based on a budget which receives Congressional oversight and, of course, there is the added oversight of the Government Accounting Office similar to the monitoring which the State Auditor's Office exercises over the Texas Department of Banking. Overall, I believe the general annual assessment method used by the federal agencies is superior to the method used by the Texas Department of Banking.

Part (d): In what ways can state or federal bank regulatory agencies maintain or achieve more independence from the industry they regulate?

Response: I believe an appropriate level of independence currently exists between regulators and the industry. State bank regulatory agencies and the three federal bank regulatory agencies, OCC, FDIC and Federal Reserve all have a high degree of integrity and strict standards of conduct. All appear sufficiently insulated from industry pressures to preclude the undesirable influences which contributed to the thrift industry debacle. Open lines of communication are, however, maintained with the industry directly and through their representative trade associations to assure a mutual awareness of evolving issues and/or potentially systemic problems. The benefits and necessity of a "cooperative yet adversarial" relationship are recognized and respected by bankers and regulators alike. The legal and administrative framework for independence is currently adequate; however, independence can be achieved and maintained only through appointment of agency heads who are truly independent and who will exercise independent judgement.

Question 3, Part (a): Federal regulators, notably the Comptroller of the Currency and the Chairman of the FDIC, are debating what level of capital is appropriate for banks. Do you believe that the banking industry is sufficiently capitalized?

Response: A month ago in my testimony before the Committee I responded to a similar question by rhetorically asking, "How much is enough?" To be more specific in responding to your question today, I offer the following observations: The level of equity capital held by state banks in Texas has increased from 7.1% at June 30, 1988 to 7.3% at June 30, 1989. For national banks in Texas, the ratio of equity capital to total assets has increased from 3.5% a year ago to 4.2% at June 30, 1989. For state and national banks combined, the level of equity capital relative to total assets has risen from 4.4% to 4.9%.

Looking at primary capital, i.e. equity capital plus loan loss reserves, the ratio for state banks remained steady at 8.3% from June 1988 to June 1989 whereas the ratio for national banks decreased to 5.5% from the 6.3% level a year ago. On a combined basis, the total capital-to-primary assets ratio dropped from 6.8% on June 30, 1988 to 6.2% in June 1989. These changes reflect the elimination of bad loans, the building up of reserves, and the overall efforts of Texas banks to clean up the quality of their loan portfolios and bolster their capital bases.

As I stated in mid-October, I am pleased to see the level of capital stabilizing and beginning to build; however, I would prefer a higher level of equity capital. So in that regard I do not yet feel the industry is sufficiently capitalized. Further, the deregulated banking industry is much risker now than it was previously when we had a regulated and more stable economic environment, yet since those times capital levels have declined. Also, given the current deposit insurance mechanism, I believe higher capital standards provide an alternate market discipline to lowering deposit insurance maximums, namely putting investors' capital at risk.

Part (b): Do I favor increasing or decreasing capital levels?

Response: I favor increasing equity capital to a level higher than currently exists, although I'm not sure what specific level or ratio is the magic number or most appropriate minimum level.

Part (c): Do I agree that a 6% non-risk adjusted capital requirement (i.e. a minimum leverage ratio) should still be mandated after the risk-adjusted capital standards go into effect?

Response: Yes, I believe there should be some form of required minimum leverage ratio in addition to the risk-based capital requirements. What that minimum ratio should be, I am not sure.

Under the risk-based capital requirements it is conceivable, though highly improbable, that a bank could legally operate with zero equity capital. This could be done by confining its assets solely to cash or cash equivalents such as U.S. Treasury issues which have a 0% risk weighting. Even given such an unlikely situation, I do not feel a zero capitalized institution is prudent.

Risk-based capital requirements obviously have their genesis in tieing capitalization levels to the degree of risk inherent in various banking activities. I believe we as regulators must place more emphasis on monitoring and regulating the risk-taking activities of banks rather than focusing too much on maintenance of an arbitrary capital level; but at a minimum, I do feel there must be a floor level of capital for any bank. At present, the Texas Banking Department is using a 6% equity ratio (exclusive of a fully-funded loan loss reserve) as that floor level. Finally, I believe the 8% risk-based capital ratio is the crux of the problem. 8% is too low. Compare the 8% *risk-based* ratio to the current primary capital *leverage* ratio of 8.3% for state banks in Texas.

Question 4, Part (a): Are state chartered banks in Texas permitted to engage in real estate investment and development either directly or through a subsidiary?

Response: No.

Part (b): What was the policy justification for such authority?

Response: Not applicable since no such authority exists.

Part (c): Do I have concerns about these powers?

Response: First let me say that I do not favor granting authority for banks to engage in real estate investment and development or insurance underwriting. I would, however, favor nontraditional powers such as securities underwriting and insurance and real estate sales activities which can help banks to diversify their sources of income and reduce the cost of these services to consumers. I must emphasize that these new powers should be subject to proper controls and limits to avoid the abuses which might be detrimental to the bank overall.

When the thrift industry was granted real estate investment and development powers, such authority was granted without concurrently providing for appropriate limits or regulation and supervision. Statutory safeguards to prevent unsafe and unsound risk acceptance were not enacted, and the staffing levels and expertise of regulatory agencies were at the time inadequate to properly monitor the activities. I believe banks should be allowed to prudently and profitably access new, non-traditional sources of income, especially insurance and real estate sales and brokerage. These activities are in the nature of financial services and pose little risk to capital.

Part (d): Do other states permit direct real estate investment and development by banks?

Response: Yes. I refer you to Attachment "A" which was compiled by the Conference of State Bank Supervisors showing the various powers permitted by different states across the nation.

Question 5, Part (a): What expanded powers are permitted to banks in Texas and how are these powers regulated?

Response: Banks in Texas, whether state or national, are not permitted to engage in any expanded powers such as securities underwriting, real estate investment and development, or insurance sales or underwriting; and therefore, no regulation of such powers is necessary.

Part (b): What is the extent of such activity?

Response: Not applicable since such expanded powers are not permitted.

Part (c): As the state bank regulator, do you have a means to monitor which state banks enter into each of the above activities?

Response: Present bank statutes do not allow state or national banks in Texas to engage in the expanded powers mentioned. If such activities were to be allowed in the future, I am confident we would have the means to properly supervise and regulate the activities and that necessary enabling legislation would be concurrently enacted.

Question 6: FIRREA gave FDIC the authority to assess solvent bank affiliates in a multi-bank holding company system for the costs of a failed bank, e.g. the "cross-guaranty" provision. This authority has already been used in the case of a failed state bank and an affiliated but solvent national bank, both in Texas. How did it work and is it a good idea?

Response: This newly acquired power of the FDIC was initially challenged in the courts; but it is my understanding that the matter has since been settled in a manner which justifiably assesses the shareholders' equity at the solvent bank while also preserving the viability of the solvent bank.

The cost test utilized by the FDIC in determining how to resolve a failed bank is a closely-guarded computation. Based on historical data, however, the discount being applied by prospective bidders for failed banks is in the range of 20-25%. Using best-guess estimates of the costs to the FDIC fund, it appears that the resolution cost of the failed state bank in this Texas case was less than the ultimate resolution cost if both banks had failed.

The rationale underlying the cross-guaranty provision contained in FIRREA is unquestionably appropriate. The FDIC should have the authority to access all available assets of a banking system to offset the resolution cost of a single or several failed subsidiary banks. Afterall, in most instances, multi-bank holding companies were established to achieve a wider geographical presence in unit banking states which prohibited statewide branching. Operationally, however, most such multi-bank holding company systems function as a single unit. Capital is dividended out of highly capitalized subsidiaries and reallocated through the parent holding company to under-capitalized banks. Taxable losses of one or more subsidiaries are offset against taxable profits at others to minimize consolidated tax liability. Asset-liability management, budgeting, data processing, etc. are handled centrally for the benefit of the combined entity. Functionally, though not legally, a unified banking organization is achieved having numerous operating locations. The whole is the sum of the parts, so why shouldn't the whole have to pay for the cost of failure of a part?

There appear to be at least two disadvantages to applying the cross-guaranty provision. First, in most instances it appears that the resolution cost of failure of a larger or equal size affiliate bank would cause the remaining solvent banks in the system to be insolvent or mortally wounded, i.e. imminently insolvent. The discount factor applied by prospective bidders of failed banks thus results in an aggregate greater cost to the FDIC fund than if only the single insolvent bank were charged against the fund.

A second disadvantage of the cross-guaranty provision is that it applies only to affiliated banks within a multi-bank organization. In some instances, notably the MCorp situation, significant asset values may be contained in nonbank affiliates which operate data processing facilities, credit card facilities, trust operations, etc. Also, the parent holding company itself may hold assets of significant value. Certainly these parts comprise a portion of the whole, yet they are not under the umbrella of the FDIC's cross-guaranty provision in FIRREA, In the future, I believe bank holding companies may move more of their operations and valuable assets to non-bank subsidiaries to shelter assets from the reach of the FDIC. In this aspect, FIRREA needs to give more authority and flexibility to the FDIC.

Question 7, Part (a): Why are external audits misleading?

Response: As I mentioned on page 13 of my earlier testimony, external opinion audits prepared by accounting firms have traditionally placed primary emphasis on the fairness of financial statements relative to quantitative accounting rules, i.e. GAAP or generally accepted accounting principles. On a purely quantitative basis, the financial statements may have been accurate; but on a qualitative basis, the statements may have shown much worse.

Therein lies the rub -- auditing tended to focus on historical charge-off and recovery trends, industry loan loss ratios, and the representations of management to assess the adequacy of the loan loss reserve account. Examiners, on the other hand, focused more on analyses of individual loan quality and collectibility, the validity and underlying assumptions of asset appraisals, and on their own knowledge of localized economic and industry conditions. By using this later approach, bank examiners frequently arrived at a much larger dollar amount for the reserve account. The end result? Publicly disclosed auditors' reports portrayed a stronger (and possibly misleading) financial condition than did confidential examination reports.

Recognizing that no one individual nor professional group deserves a lion's share of the blame, I must acknowledge that even the best accounting firms may not have been able to produce a fully accurate and fairly disclosed audit report. Neither did state or federal examiners. We, too, did not foresee adequately the problems in real estate. Deterioration in asset values during the mid-1980s was so rapid and pronounced that by the time as audit report was issued, its findings were already inaccurate.

For example, suppose an audit was performed as of year-end 1985. Asset appraisals upon which collateral valuations and reserve adequacy were based may have dated back to early 1985 or even into 1984 -- one to two years before the audit date and up to two and one-half years before issuance of the audit report. In that 12 to 30-month time span, the values of many Texas oil rigs, commercial buildings, strip centers and development real estate declined dramatically. Thus, an institution may have been given a clean bill of health when, in fact, it was desperately ill.

Part (b): What needs to be done to make external audits worthwhile?

Response: I believe the accounting industry is already addressing the need to more thoroughly reflect the adequacy of asset valuation accounts. The accounting profession is also placing more emphasis on the qualitative presentation of financial statements. Rather than attempt a legislative fix to a perceived problem, I believe closer communication between auditors and examiners will provide the necessary self-correction to this situation.

In Texas, the Department of Banking has encouraged banks as early as two years ago to invite auditors to attend discussions between bankers and examiners. Examiners and auditors have also been urged to freely share workpapers and methodologies with each other. The old adage "two heads are better than one" seems very appropriate in this situation. Mutual cooperation and a better understanding of a bank's condition will inevitably lead to a more accurate portrayal of financial health.

Regarding recent proposals that a change to market value accounting be adopted, I do not believe market value accounting is necessary or desirable. Banking problems in Texas were not a result of inaccurate reporting; they were the result of inadequate analysis and poor judgement in the lending function.

Question 8: What effort is the Texas Banking Department making to detect bank fraud, prosecute criminal misconduct, and prevent unsuitable persons from entering the banking industry as owners, directors or managers?

Response: Banks have always been required under federal regulations to report to the FDIC instances of apparent criminal activity or irregularities. (See Part 353 of the FDIC Rules and Regulations.) While it is certainly appropriate that a bank's board of directors should have the responsibility to report such apparent criminal activity, there is the natural tendency for bankers and bank directors to not want to tell the authorities of their own misconduct. To alleviate this situation and aid in more thoroughly reporting possible misconduct, we have recently developed our own report of apparent criminal activity. (See attachment "B".) The report is completed by examining personnel for egregious and significant violations when situations become known. It is then sent directly to prosecuting authorities for follow-up action. In addition, a log of such reports is now maintained and periodic contact will be made with the prosecuting agencies to see what action is being taken and what progress being achieved. We are also trying to establish staff level lines of communication with responsible federal enforcement officials.

Finally, as I mentioned briefly on pages 16 through 19 of my earlier testimony, the Texas Department of Banking has redirected its supervisory approach to focus on *leading* indicators and undesirable bank practices. In so doing, we are attempting to apply the "ounce of prevention" methodology to bank supervision and regulation. Early detection of inappropriate or objectionable banking practices allows more time and flexibility for correcting the underlying problem(s). In some cases, correction is primarily an educational endeavor, persuading bank managers to modify their methods or prompting bank directors to become more actively involved in the oversight of bank policies and executive officers. In other cases, however, correction may involve removal of the offending officer(s). Legislative changes enacted by the Texas Legislature just this year now permit quick and decisive action in this regard. Upon identification of harmful banking practices, offending bank officers can be removed and the detrimental activity stopped immediately before further damage threatens viability of the bank.

It may also be worth noting at this point that regulatory agencies have the authority to deny charters or changes of control unless acceptable management is provided. As a chartering authority, the State Banking Board must consider five factors in making a determination to grant or deny a charter application. Among these factors is the requirement that "The proposed officers and directors have sufficient banking experience, ability and standing to render success of the proposed bank probable;" (Art. 342-305(A)(4) of The Texas Banking Code). A similar requirement is made for changes of control of an existing bank (Art. 342-401a(C)(4).

Barring an individual or removing him from the position of a bank manager can be a difficult task unless the person has clearly been guilty of egregious conduct which was detrimental to a financial institution. Too heavy-handed regulation is just as inappropriate as too lenient regulation. Neutralizing the potential for engaging in bad banking practices is a primary thrust. This is accomplished by insisting that banks adopt comprehensive policies and procedures to assure the necessary checks and balances in a bank's operations. Adherence to policies and procedures is a close secondary thrust accomplished by a combined system of annual on-site examinations and continuous off-site monitoring of financial data.

Preventing unsuitable persons from entering the banking industry as either owners or directors is another matter. Given the concept of freedom upon which these United States were founded, how do we prevent an individual from owning bank stock? Or at what point does an individual become so unsuitable that he no longer qualifies to own bank stock? I believe our efforts are most appropriately directed at activities often associated with ownership rather than at ownership itself. If we as regulators adequately control the degree of risk which may be accepted and the types of risk-taking activities in which a bank may engage, then the suitability or unsuitability of the owner becomes a non-issue.

The same is partially true of preventing unsuitable persons from becoming bank directors. Statutes presently exist which bar persons who have been convicted of a felony from being an officer or director of an FDIC insured bank. Also, The Texas Banking Code prohibits anyone from serving as director of a state bank if the bank holds any form of charged-off obligation for that person. But, assuming that an individual is neither a convicted felon nor owes a bank for a charged-off obligation, then he or she is eligible to be elected by the shareholders to the bank's board of directors.

As I mentioned in the case of bank owners, we as regulators must strive to control the amount of undesirable influence that a bank director can exert by controlling the types and amounts of risk that a bank accepts. I believe we have the necessary tools to do this, and I believe that with our increased emphasis on undesirable banking practices, leading indicators and portfolio management, we can neutralize and largely eliminate the damaging influences of unsuitable owners, directors or managers in the banking industry.

Question 9: Have recapitalizations of troubled banks been successful in Texas? If not, why not?

Response: In answering your question, let me first distinguish between "failed" banks and "troubled" banks. In the case of failed banks, the FDIC has been very successful in resolving the situations. However, in the case of FDIC-assisted recapitalizations of troubled but still open banks, i.e. 13(c) assistance transactions, the FDIC's efforts have, for the most part, been unsuccessful in Texas. None of the assisted banks, and there have been very few, have yet failed; however, the largest assistance transaction, BancTexas, is now back at the federal trough for a second time to avoid failure. Recapitalizations of other smaller community banks have not yet resulted in second requests for FDIC assistance, but most of these banks are in a tenuous condition and their ultimate survivability is questionable.

Why has this been the case? Probably the best answer is "too little, too late". In virtually all 13(c) FDIC assisted transactions, the request for and subsequent approval of assistance was after the bank was too far gone to be rehabilitated. In some instances, when application was made early on, the request was denied because the bank had "too much capital to qualify for assistance". Then, when capital support had eroded further and overall condition was much worse, assistance was denied because it was less costly to the insurance fund to resolve the situation through a routine bank failure transaction. In essence, the posture of the FDIC in providing 13(c) assistance has created a "no-win" situation for troubled banks.

Earlier this year I submitted to the FDIC a proposal for providing 13(c) assistance to troubled banks at a time early enough to maximize the chances of success of the assistance. The proposal (see Attachment "C") was structured such that a pool of poor quality assets would be mutually identified by the FDIC, the banker and new investors. 13(c) assistance would then be used to "underwrite" that pool of troubled assets in return for an injection of new capital from either existing shareholders or new shareholders. Future losses emanating from this pool would first be charged against the equity and reserves of the pre-assistance shareholders, then against tne FDIC provided assistance capital (up to a pre-set limit), and then against the newly injected capital.

My proposal created the upside potential necessary to induce new or existing shareholders to invest fresh capital into the bank. It also created upside for the FDIC by reducing the potential ultimate cost to the fund. It stands to reason that saving a bank well before failure should be no more costly than resolving a bank after failure due to the preservation of assets and franchise value. The downside risk to the insurance fund was limited to that which might otherwise have been incurred if the bank were allowed to fail in a routine manner.

The key to this proposal was to identify banks which were in failing health but not yet insolvent. The plan was designed for banks which had a reasonable chance of being rehabilitated if given timely assistance. The emphasis was on avoiding a failure rather than waiting for death and disposing of the corpse.

Questions from Senator Jake Garn:

Question 1: How many more banks will fail in Texas before the situation there stabilizes?

Response: As I mentioned on page 22 of my earlier testimony, I believe that the Texas economy has begun to find solid footing and is poised for recovery. Financial institutions tend to mirror economic activity and since the timing and strength of Texas' economic recovery is as yet unclear, it will probably be some time before the financial services industry in Texas fully recovers. At this time, however, it appears that combined state and national bank failures in Texas should peak at approximately 90 for 1989 compared to 74 for 1988. (The actual number of bank charters to fail in 1989 will be approximately 132 which includes 20 failed MBanks and 24 failed Texas American Banks. Counting these multi-bank system failures as only two produces the number of 90. For 1988 there were 113 actual charter failures which included 40 failed First RepublicBanks; thus, the number 74.)

For 1990, our data suggests that state bank failures may approach 30 and, assuming a similar number of national banks will fail, the bank failure total for Texas for the year should approximate 60. In 1991 and beyond for two to three years, our best estimate at this time is that roughly 80 to 100 banks have a high probability of failure.

Question 2: Have expanded powers (such as real estate development by state banks) been proposed and debated in Texas?

Response: Direct real estate investment and development powers for Texas banks have not been formally proposed or debated. Insurance sales authority, which would be a relatively riskless fee-income generating activity for banks, was proposed to the Finance Commission; however, the insurance lobby and the State Insurance Board strenuously objected and the proposed regulation was withdrawn. The issue is not being pursued further at this time nor is any action being taken to permit banks to engage in securities brokerage activities.

Question 3: Do you believe that the real estate reform provision of FIRREA will improve that industry and protect the FDIC fund from future losses?

Response: Title XI of FIRREA deals with the regulation of real estate appraisals, It defines which transactions require an appraisal, establishes licensing procedures for appraisers and sets forth the criteria which appraisals must satisfy to be acceptable. Undoubtedly, the provisions relating to real estate appraisals will bring a greater measure of integrity and reliability to the appraisal industry and its product. FIRREA's provisions will not, however, control the imprudent use of appraisals by unseasoned or aggressive, growth-oriented lenders, nor will it compensate for rapidly fluctuating values and economic instability. Perhaps some measure of safety will also be gained from loan to value ratios contained in FIRREA.

Question 4: Do you believe banks should be authorized to engage in expanded powers such as real estate investment and development or securities brokerage and underwriting directly or through "firewalled" subsidiaries? Does the amount of capital support make a difference?

Response: First, let me reiterate what I said in my response to Senator Riegles's fourth question. I do not favor granting authority for banks to engage in direct real estate investment and development. However, fee generating activities such as insurance and securities brokerage could be beneficial to the public and yet involve little risk to bank capital. Whether these activities occur in a separate subsidiary of a parent holding company, directly within the bank, or in a subsidiary of the bank is not the primary issue. At issue, in my opinion, is not "where" you build the protecting firewalls, but "how" you build them.

Banks should be able to perform these activities in a wholly-owned subsidiary of the bank since the deposit insurance fund is better protected if the activity is at the bank level. Remember, the FDIC's cross-guaranty authority under FIRREA does not extend to assets held at the holding company or in a non-bank subsidiary, only to other bank affiliates.

THE CONFERENCE OF STATE BANK SUPERVISORS

STATE AUTHORIZATION OF SELECTED EXPANDED ACTIVITIES FOR STATE-CHARTERED BANKS*
MARCH 1989

Insurance Underwriting
- Delaware [1]
- North Carolina
- South Carolina
- South Dakota
- Utah [1]

Insurance Brokerage
- Alabama
- California
- Indiana [8]
- Iowa [9]
- Nebraska
- New Jersey
- North Carolina
- Oregon
- South Carolina
- South Dakota
- Wisconsin
- Wyoming

Real Estate Equity Participation
- Arizona
- Arkansas
- California
- Colorado
- Connecticut
- Florida
- Kentucky
- Maine
- Massachusetts
- Missouri
- Nevada
- New Hampshire
- New Jersey
- North Carolina
- Ohio
- Rhode Island
- South Dakota
- Tennessee [2]
- Utah
- Virginia
- Washington
- West Virginia
- Wisconsin [3]

Real Estate Development
- Arizona
- Arkansas
- California
- Colorado
- Connecticut
- Florida
- Kentucky
- Maine
- Massachusetts
- Michigan
- Missouri
- Nevada
- New Hampshire
- New Jersey
- North Carolina
- Ohio
- Rhode Island
- South Dakota
- Utah
- Virginia
- Washington
- West Virginia
- Wisconsin [3]

Real Estate Brokerage
- Iowa
- Massachusetts
- New Jersey
- North Carolina
- Oregon
- Wisconsin

Securities Underwriting
- Arizona
- California [6]
- Delaware
- ~~Florida~~
- Indiana [5]
- Iowa
- Kansas [10]
- Maine
- Massachusetts
- Michigan
- Missouri [4]
- Montana [7]
- New Jersey
- North Carolina
- Pennsylvania [11]
- Washington
- West Virginia

Securities Brokerage/
- Arizona
- Connecticut
- Delaware
- Florida
- Georgia
- Indiana [5]
- Kansas
- Iowa
- Maine
- Maryland
- Michigan
- Minnesota
- Nebraska
- New Jersey
- New York
- North Carolina
- Ohio
- Pennsylvania [11]
- Texas
- Vermont
- West Virgina

* Expanded activities above those permitted national banks and bank holding companies under the Bank Holding Company Act. Extent of practice unknown.

[1] Grandfathered institutions.
[2] Banks not allowed to be active partners in real estate development.
[3] Wisconsin -- Enacted expanded powers legislation 5/86. New legislation authorized the Commissioner of Banking to promulgate rules under which state banks may engage in activities that are authorized for other financial institutions doing business in the state.
[4] Underwrite mutual funds and may underwrite securities to extent of the state legal loan limit.
[5] Underwrite municipal revenue bonds and market mutual funds and mortgage backed securities.
[6] Underwrite mutual funds; law silent on other securities.
[7] Limited to bonds.
[8] Cannot broker life insurance, all other types permitted.
[9] Property and casualty only.
[10] Underwrite municipal bonds.
[11] Underwrite municipal and mortgage related securities to extent permitted savings banks.

THE CONFERENCE OF STATE BANK SUPERVISORS

State Authorization of Expanded Insurance Powers for State-Chartered Commercial Banks*

March 1989

* Generally, activities require prior approval.

State	Insurance Brokerage/Agency	Insurance Underwriting	Limitations	Authorizing Statute/ Regulation
AL	Yes	No	Incidental powers which must be interpreted by Superintendent; at present, interpretation does not include insurance underwriting.	Alabama Banking Code Sect. 5-5A-18 (11), 1984.
CA	Yes	No	Apply to insurance department and file business plan within 10 days. Limited to sales, no underwriting.	
IN	Yes	No	Cannot broker life insurance. Activity not required through a subsidiary.	I.C. 28-1-11-2, 1933.
IA	Yes	No	Property and Casualty only. No separate subsidiary required.	Legal memorandum dated 11/7/83.
NE	Yes	No	Permits bank to act as agent for any fire, life, casualty, company in any community whose population is less than 200,000.	Policy statement #9, par 1, effective 5/9/83. NB Rev. Stat. Sect. 44-392, 1933 as amended 1977.
NJ	Yes	No	3% aggregate of total assets of 50% of capital, surplus, reserves, individual profits & capital notes whichever is smaller.	N.J.S.A. 17:9A-24.12 & 24.13, N.J.A.C. 3:11-11, 1985.
NC	Yes	Yes		Through department authorization.
OR	Yes	No	Insurance activity must be physically separate from banks, (a wall or partition separating from bank) different names, different employees.	ORS 707.310, 746.195, effective 7/20/87.
SC	Yes	Yes	With Board of Bank Control approval may invest up to 15% of total capital & surplus in one subsidiary corporation doing business incidental to banking or aggregate investments of 50% of capital & surplus.	Regulation 15-1, 1976.
SD	Yes	Yes		SD Code 51-18-30, 1983.
WI	Yes	No	Specific guidelines & procedures for activity are spelled out in Bank Letter #38. Written approval of Commissioner is required.	WI Stat. Section 221.04 WI Stats: amended 5/86. Bkg. Ltr. #38, dated 11/28/83.
WY	Yes	No	Insurance agency activity permitted.	Through Department authorization, no specific statutory.

THE CONFERENCE OF STATE BANK SUPERVISORS

States Authorization of Securities Activities For State-Chartered Banks March 1989

State	Authorized Activities: Underwriting	Authorized Activities: Full Service Brokerage (Without Underwriting)	Utilization of Subsidiary	Authorizing Statute/ Regulation	Limitations
AZ	Yes	Yes	Required	ARS 6-193, Effective 1987.	
CA	Yes (not prohibited but generally not practiced).	No		CA. Fin Code 772, 10.19143, Effective 1/1/83.	"After market" including general obligations of US, and CA + local CA agencies. Obligation of a single obligor held by a bank may not exceed 15% of shareholders' equity of a bank.
CT	No	Yes	No	No statutory prohibition 36-57, 96, 178-leeway provisions.	
DE	Yes	Yes	No	Section 761, 767, Title 5, DE Code, effective 5/20/87.	
FL	No	Yes	No	Effective 10/1/84	Limitations include total investment as a certain percentage of the capital accounts.
GA	No	Yes	No	Reg. 80-1-4-.01 (5)	Proper license through the state securities commissioner required.
IN	Yes	Yes	Yes	IC 28-1-11-4, effective 3/88.	Limited to underwriting municipal revenue bonds and marketing mutual funds and mortgage-backed securities.
IA	Yes	Yes	No	IA Statutes - 524.825. effective 1987.	No rules have been promulgated as yet.

THE CONFERENCE OF STATE BANK SUPERVISORS

States Authorization of Securities Activities
For State-Chartered Banks
March 1989

State	Authorized Activities: Underwriting	Authorized Activities: Full Service Brokerage (Without Underwriting)	Utilization of Subsidiary	Authorizing Statute/ Regulation	Limitations
KS	Yes	Yes	Yes	KSA 9-1101, New law, effective 3/88.	Invest 15% of capital & surplus may underwrite municipal bonds. Limited to mutual funds.
ME	No	Yes	No	Regulation #22, effective 6/18/85.	
MD	No	Yes	No	Law is silent.	
MA	Yes	No	No	MGL Ch. 176 F2.	
MI	Yes	Yes	No	Public Act No. 200, Section 154, effective 8/1/88.	To extent permitted by order of Commissioner.
MO	Yes	No	No	MO Banking Code Section 362.105 and 4 CSR 140-6.070. Effective 8/13/86 for mutual funds and financial counseling.	Regulators believe banks can underwrite securities and participate in "After Market" to the extent of the state legal loan limit. New law authorizes banks to underwrite mutual funds and provide financial counseling.
MN	No	Yes		Law is silent. Licensing under securities law.	
MT	Yes	No	No	MT Banking Code Section 32-1-433 effective since 1933. Amended 1983.	May not purchase or underwrite any bond issue in excess of 50% of unimpaired capital & surplus except for US obligation. GOs of MT or other cities, towns, counties, or school districts for this state.
NE	No	Yes		NE Banking Policy Statement #9, par. 13 effective 5/9/83.	

THE CONFERENCE OF STATE BANK SUPERVISORS

States Authorization of Securities Activities
For State-Chartered Banks
March 1989

State	Authorized Activities		Utilization of Subsidiary	Authorizing Statute/ Regulation	Limitations
	Underwriting	Full Service Brokerage (Without Underwriting)			
NJ	Yes	Yes	No	17:9A-24.12.13 effective 5/17/85 and Reg. 3:17-(17-1) (11.9) effective 7/86.	3% aggregate of total assets or 50% of capital, surplus, reserves, individual profits & capital notes, whatever is smaller.
NY	No	Yes	Required	NY Banking Law 96.1, 103.9, 130.4 and 143, effective 1986.	Limitations currently being drafted will clarify securities activities.
NC	Yes	Yes	Required	G.S. 53-47, as amended 1983.	Full-service brokerage not prohibited, but would have to be done through ownership of a company.
OH	No	Yes	Required	OH Banking Code 1107.14 effective 1968 + 1107.39 effective 1987.	Subject to practice in a bonafide subsidiary.
PA	Yes	Yes	No	PA Banking Law Act No. 173, effective 1988.	Limited to municipal and mortgage related securities.
TX	No	Yes	Required	TX statutes 3-1 through 3-6, effective 8/85.	Subject to bonafide subsidiary requirement.
VT	No	Yes	May be required	8 VSA, Sect. 606, effective 7/1/87.	Regulations not yet written.
WA	Yes	No	No	WAC 50-12-110 through WAC 50-12-112; RCW 30.04.215. Effective 10/9/87.	May only underwrite industrial revenue or other revenue bonds issued by public improvement agency.
WV	Yes	Yes	No	31A-8C(1-5), effective 3/88.	10% aggregate capital and surplus.

THE CONFERENCE OF STATE BANK SUPERVISORS

State Authorization Of Real Estate Powers For State Chartered Banks
March, 1989

State	Development Of Real Estate Allowed?	Utilization Of A Subsidiary Required?	Authorizing Statute/ Regulation	Limitations	Practice as of 9/87
1) Arizona	Yes	Yes	A.R.S. Section 6-184.467, 1983	None Established	Limited to a few banks.
2) Arkansas	Yes	No	Ark. Stat. Sec. 67-501.1P, 1985	By Statute-20% of bank capital surplus and undivided profits.	
3) California	Yes	No	751.3 Financial Code, 1982, effective 1984.	By Regulation-Total investment may not exceed 10% of total assets if invested through a subsidiary. If direct, investment may not exceed shareholder equity, unless superintendent approves a higher percentage.	63 banks active, for about 1% of their assets.
4) Colorado	Yes	No	Colorado Revised Statute 11-7-106 (10)(a), 1985	By Statute- Total investment may not exceed 10% of total assets.	Information unavailable
5) Connecticut	Yes	No	Conn General Stat. Secs. 36-57(r), (y), (aa), and (t)(3), 1985	By Statute- Bank may invest 8% of assets in unrestricted investments. Bank may also invest up to 10% of equity in a business engaged in real estate investment.	Banks moderately engaged.
6) Florida	Yes	Yes	Section 658.67(6) 1985	By Statute- Bank may invest up to 20% of total assets in a real estate subsidiary.	10-15% of banks practicing.
7) Kentucky	Yes	No	KRS 287.100 (10) July, 1986	By Statute- 10% of paid-in capital and surplus. Investments limited to the bank's generally accepted market.	Virtually no activity
8) Maine	Yes	No	Title 9-B MRSA 441, 1981	By Statute- Aggregate amount combined with fixed assets is limited to 60% of total capital and reserves, or 60% of surplus account.	Limited activity

THE CONFERENCE OF STATE BANK SUPERVISORS

State Authorization Of Real Estate Powers For State Chartered Banks
March, 1989

State	Development Of Real Estate Allowed?	Utilization Of A Subsidiary Required?	Authorizing Statute/ Regulation	Limitations	Practice as of 9/87
9) Massachusetts	Yes	No	MGL Chap. 167F Sec. 2 Subsec.8 1982	By Statute- 2% of deposits to any single entity, and 5% of deposits in the aggregate. Permitted real estate brokerage--source unknown.	90% of thrifts practicing. No information on commercial banks. Source unknown.
10) Michigan	Yes	No	Public Act 104, Effect. 7/87	Banks may invest up to 10% of their assets in the purchase and development of real estate.	Not available as yet.
11) Missouri	Yes	No	Section 362.106 RSMo. 4 C.S.R. 140-2.065, September, 1985.	By Statue- Investment in real estate subsidiary may not exceed 5% of assets. Bank's investment in any one project may not exceed 20% of its unimpaired capital.	One bank active.
12) Nevada	Yes	No	NRS 662.103, July, 1986.	By Statute- 100% of capital or 10% of assets, whichever is less.	Minimal activity (1-2 banks active)
13) New Hampshire	Yes	Yes	384:16-b (10-85) 387:20-a (10-85)	By Statute- $10,000,000 or 5% of deposits, whichever is less. Also, bank's investment in any one subsidiary limited to 2.5% of deposits.	60% of banks active.
14) New Jersey	Yes	No	NJSA 17:9A-24.12, 24.13 (1985) NJAC 3:11-11.1, 1986	By Statute- 3% of assets or 50% of surplus accounts, whichever is less.	Virtually no commercial banks practicing. Limited activity by savings banks.
			NJSA 17:9A-24.9(5) 1986 NJSA 12B-165A(7) 1981	Permitted real estate brokerage--source unknown.	Practice unknown.
15) North Carolina	Yes	Yes	G.S. 53-47, 1921, amended 1983.	By Statute- May invest up to 75% of unimpaired capital in stocks of a company engaged in real estate activities.	One bank active.
				Permitted real estate brokerage--source unknown.	Practice unknown.

THE CONFERENCE OF STATE BANK SUPERVISORS

State Authorization Of Real Estate Powers For State Chartered Banks
March, 1989

State	Development Of Real Estate Allowed?	Utilization Of A Subsidiary Required?	Authorizing Statute/ Regulation	Limitations	Practice as of 9/87
16) Ohio	Yes	No	1107.05, effective 1986.	By Statute-10% of total assets or 100% of capital and unimpaired surplus, whichever is greater.	Limited activity
17) Rhode Island	Yes	No	19-9-11, 1988	By Statute- 5% of savings deposits.	Moderately active
18) South Dakota	Yes	No	SDCL 51-18-38 and 39, ARSD 20:07:03:19-22 20:07:16:07-10 (1986)	By Statute-Investments limited to minority interests with limited right of divestment.	Information unavailable
19) Tennessee	(Banks not allowed to be active partners in real estate development.)	No	45-2-607(a)(9) Rule 0180-14-02-3 effective July, 1985.	By Statute-Investments allowed to the extent that the total depreciated value thereof does not exceed the bank's capital and surplus.	1 to 2% of banks active
20) Utah	Yes	No	UC 7-3-18, R341-012-3, effective May, 1985.	By Regulation- 10% of capital stock and surplus. Bank must also have capital equal to at least 8% of its total assets when investment is made.	No activity.
21) Virginia	Yes	No	6.1-39.1, effective 1988	5% in aggregate of assets, investment in any one project limited to loan limit for one borrower.	Extent of practice unknown.
22) Washington	Yes	No	RCW 30.04.212 and 214, 1985	By Statute- Limit determined by bank's Community Reinvestment Act (CRA) rating. Banks with highest CRA rating may invest 10% of capital, surplus and undivided profits.	About 20% of banks active.
23) West Virginia	Yes	No	31A-8C-(1-5), effective 3/88	10% in aggregate of capital and surplus on a consolidated basis.	Extent of practice unknown.

THE CONFERENCE OF STATE BANK SUPERVISORS

State Authorization Of Real Estate Powers For State Chartered Banks
March, 1989

State	Development Of Real Estate Allowed?	Utilization Of A Subsidiary Required?	Authorizing Statute/ Regulation	Limitations	Practice as of 9/87
24) Wisconsin	Yes	No	Act 325, Sect. 221.295 (2)(3), April, 1986.	By Statute- Limited to 10% of capital and surplus. (Not permitted until regulations developed.)	No activity.
				Permitted real estate brokerage--source unknown.	Practice unknown.

**Source: Supervisory Procedures Committee of the Conference of State Bank Supervisors

Attachment "B"

TEXAS DEPARTMENT OF BANKING

Report of Apparent Crime(s)

This form is to be used by Texas Department of Banking employees only for purposes of disclosing any type or amount of suspected criminal violation of relevant federal or state laws. For purposes of this form, "suspected criminal activity" implies that there is a reasonable basis for believing that a crime has occurred, is occurring or may occur.

This form should be filed within thirty days following discovery of the suspected violation. The entire form should be completed, with continuation pages used as needed. If requested information is unavailable or unknown, so indicate.

The information in this report is subject to the applicable provisions of the Privacy Act of 1974, 5 U.S.C. 552a, Articles 342-705 and 342-210 of Vernon's Texas Civil Statutes.

1. Name and Location of the Regulated Entity

Name____

Location______________________________________
Street

____
City St Zip

Certificate Number______________

If the activity occurred at a location other than the entity's principal office, please identify

____

2. Asset size of the Entity____________________

3. Approximate date and dollar amount of suspected violation

Date___________________ Amount_______________________

4. Type(s) of suspected violation. Check the appropriate box(es)

Defalcation/Embezzlement ___
False Statement ___
Check Kiting ___
Bribery/Gratuity ___
Misuse of Position or Self Dealing ___
Mysterious Disappearance ___

Check Fraud ___
Credit Card Fraud ___
Money Laundering ___
Other (Please Indicate) ___
____
____

Applicable Section(s) of the federal statutes (see attached), or state statutes, including The Texas Banking Code (if known).

____

5. For each person(s) suspected of a criminal violation, please complete the following five subitems. Individuals who may have knowledge of the suspected criminal activity, but who are not themselves suspected of being involved should be listed as witnesses under item 9.

a. Name______________________________________
First MI Last

Address______________________________________
Street

____
City St Zip

Date of Birth______________ Social Security No.______________
Month Day Year

Texas Driver's License No.____________

b. Relationship to the entity (please check all applicable box(es)

Officer	___	Borrower	___
Director	___	Shareholder	___
Employee	___	Account Holder	___
Agent	___	Appraiser	___
Broker	___	Other, (Please Specify)	___

____

c. Is person still affiliated with the entity? ___yes ___no

If no, ___terminated ___resigned DATE ______________
Month Day Year

Describe circumstances of the person(s) continuing affiliation or termination/resignation. If necessary please use a continuation sheet.

d. Prior or related referrals? ___yes ___no If yes, please identify.

e. Is person affiliated with any other business entity? ___yes ___no or business enterprise? ___yes ___no If yes to either or both questions, please identify.

6. Please provide in a concise, chronological and complete manner a description of the activity(s) giving rise to the referral. Please elaborate upon the unusualness or irregularity of the transaction(s) and use a continuation sheet if necessary. In addition, please add, where applicable, all relevant account numbers. In answering this question, please ensure you do the following:

   a. Relate key events to documents and attach copies of those documents.
   b. Explain who benefitted, financially or otherwise, from the transaction, how much, and how.
   c. Furnish any explanation of the transaction provided by the suspect and indicate to whom and when it was given.
   d. Furnish any explanation of the transaction provided by any other person.
   e. Furnish any evidence of cover-up by the suspect or evidence of an attempt to deceive state or federal examiners or others.
   f. Indicate where the suspected violation(s) took place (e.g. main office, branch, other).
   g. Recommend any further investigation that might assist law enforcement in fully examining the potential violation.
   h. Indicate whether the suspected violation appears to be an isolated incident or whether it relates to other transactions.

7. If any pertinent information has been excluded from this referral as a result of any legal or other restraint, please specify.

8. Has suspected individual(s) made any admission? ___yes ___no If so, who and what.

9. **Witnesses**
List any witnesses who might have information about the suspected violation and describe their position or employment. Indicate if they have been interviewed, and if yes, by whom.

	Name	Position	Telephone	Interviewed Yes	No	Interviewer
1.						
2.						
3.						
4.						
5.						
6.						
7.						
8.						
9.						
10.						

10. **Discovery and Reporting**

a. Who discovered the suspected violation and when?

b. Has the suspected violation been reported to the Board of Directors?
___yes ___no By whom and when?

c. Has the Board of Directors taken action? ___yes ___no
If yes, what type and when?

d. Has the suspected violation previously been reported to federal or local law enforcement or to any state or federal supervisory agency? ___yes ___no
If yes, by whom, to whom, and when?

11. Loss

a. Amount of loss known $____________________
b. Restitution by ____________________
In the amount of $____________________
c. Name of Applicable Surety Bond Company ____________________
d. Amount of Bond $____________________
e. Amount of Deductible $____________________
f. Was claim filed? ___yes ___no If yes, when ____________________
Month Day Year
g. Settlement by Surety Company $____________________
h. Total restitution and settlement to date $____________________
i. Net loss (after any amounts paid in the form of restitution or settlement) $_____
j. Is additional loss suspected? ___yes ___no (If yes, please explain.)

k. Has the suspected violation had a material or other affect on the financial soundness of the institution? If so, please explain.

12. Offer of Assistance

The individual(s) listed below are/will be authorized to discuss this referral with appropriate law enforcement officials and regulatory personnel as well as assist in locating or explaining any documents pertinent to this referral, provided that contact is first made with:

Name____

Position______________________________________

Phone No._____________________________________

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

Name Tele. No.

13. Form Prepared by:

Name Position

Agency/Institution

Phone No. Date

PRINCIPAL TEXAS CRIMINAL STATUTES

Significant Banking Code Provisions:

Art. 342-401	Failure to notify the Banking Commissioner of a transfer of stock made by a state bank.
Art. 342-401a	Willfully making false or misleading statements to the Banking Commissioner.
Art. 342-413	Embezzlement or willful misapplication of bank funds by any officer, employee or agent of the bank.
Art. 342-414	Knowingly making false entries upon the books or records of a financial institution.
Art. 342-415	Concealment, destruction, or removal of bank records by an officer, director, employee, or stockholder of a bank in order to withhold information from the Banking Commissioner.
Art. 342-416	Certification for payment of a check issued by a drawer who the officer or employee knows to have insufficient credit in his account to pay such a check.
Art. 342-417	Demand or receipt of a bonus by an officer, director, or employees of a bank in exchange for the making of a loan, investment or purchase.
Art. 342-510	Loan of funds held in trust by a bank to any officer, director or employee of the bank.

Significant Penal Code Provisions:

§31.03	Consolidated theft statute including: embezzlement, theft by false pretext, swindling, and swindling by worthless check.
§32.21	Forgery: Wrongful or unauthorized alteration, completion or making of any printed record of information, money, or other document symbolic of ownership.
§32.32	Making of false statement to obtain property or credit, to include loans or endorsements, for personal benefit.
§32.33	Concealment, destruction or transfer of property in order to obstruct recovery by potential creditors.
§32.35	Receiving a deposit, premium, or investment in a failing financial institution not insured by the federal government.
§32.43	Solicitation or acceptance of a benefit by a fiduciary in order to influence his management of property entrusted to him.
§32.45	Misapplication of fiduciary property or property of a financial institution such that the property is exposed to a substantial risk of loss.
§32.46	Securing the making or execution of a document by deception of a person in an attempt to defraud or harm.
§32.47	Fraud, destruction, removal, or concealment of written information, money, credit cards, identifying documents or other like materials.
§32.48	Issuance of checks on red or other colored paper in an attempt to prevent photostatic reproduction.
§71.02	Engaging in organized criminal activity. Conspiring with others to engage in unlawful acts.

PRINCIPAL FEDERAL CRIMINAL STATUTES

18 U.S.C. 2	To "aid, abet, counsel, command, induce or procure" the commission of a federal offense.
18 U.S.C. 201	Bribery of public officials, including elected representatives, jurors and employees of any department or agency of the federal government, and witnesses in official proceedings; e.g., anyone who gives, offers or promises anything of value to a public official or a witness with the intent to influence that person's official functions.
18 U.S.C. 215	Kickbacks, bribes. Makes it unlawful for any officer, director, employee, agent or attorney to corruptly solicit, offer, accept or receive anything of value with the intent to influence, be influenced, or be rewarded in connection with any transaction or business of any financial institution.
18 U.S.C. 371	Conspiracy of two or more persons to either commit a federal offense or to defraud the United States (or any agency of the U.S.).
18 U.S.C. 656	Theft, embezzlement or misapplication of bank funds, willfully, by an officer, director, agent or employee of a bank, with intent to injure or defraud the bank. Can infer intent to injure from the fact of injury or from acts knowingly done in reckless disregard for the interests of the bank.
18 U.S.C. 700	False advertising or misuse of words "National," "Federal Reserve," Deposit Insurance," etc., to convey impression of federal agency affiliation.
18 U.S.C. 1001	General false statements statute -- knowingly and willfully falsifying or concealing a material fact or making a false statement or making or using false writing knowing it to be false.
18 U.S.C. 1005	False entries and reports or statements, including material omissions, with intent to injure or defraud the bank, the OCC (or Fed or FDIC), bank examiners or other individuals or companies.
18 U.S.C. 1007	False statements or willful overvaluation of any security for the purpose of influencing, in any way, the action of the FDIC.
18 U.S.C. 1014	False statement (oral or written) e.g., loan application, made knowingly for the purpose of influencing any bank whose deposits are federally insured, upon any application, purchase agreement, commitment, loan (or any change or extension of same) including willfully overvaluing land, property or security.
18 U.S.C. 1029	Credit Card fraud -- knowingly and with intent to defraud, produce, use or traffic in counterfeit access devices.
18 U.S.C. 1030	Computer fraud -- knowingly accessing a computer without authorization or using it for unauthorized purposes, including obtaining information contained in records of financial institutions.
18 U.S.C. 1341	Mail fraud -- scheme or artifice to defraud that makes use of the Postal Service.
18 U.S.C. 1343	Wire fraud -- scheme or artifice to defraud using transmission by wire, radio or TV for the purpose of carrying out the scheme.
18 U.S.C. 1344	Bank fraud -- scheme or artifice to defraud a federally insured institution or take money, funds, credits, assets, securities or other property by misrepresentation.
18 U.S.C. 1621	Perjury/false statement made under oath (if false statement is not made under oath, individual may still be prosecuted under 18 U.S.C. 1001 or 1014)
18 U.S.C. 1956	Laundering of monetary instruments. Includes knowing conduct designed to avoid Federal or State transaction reporting requirements.
18 U.S.C. 1957	Engaging in monetary transactions in property known to have been derived from specified unlawful activity. Includes knowing engagement in monetary transactions (including deposits, withdrawals, transfers, or exchanges), by, through, or to a financial institution.
18 U.S.C. 1962 18 U.S.C. 1961	Racketeer Influenced and Corrupt Organizations ("RICO") statutes. Investing in any enterprise affecting interstate commerce if the funds for the investment are derived from "a pattern of racketeering activity" (these activities are defined to include murder, drug dealing, bribery, robbery, extortion, counterfeiting, mail fraud, wire fraud, embezzlement from pension funds, obstruction of criminal investigations, fraud in the sale of securities, etc.).
31 U.S.C. 5311 31 C.F.R. 103	Currency Transactions/Bank Secrecy Act.
31 U.S.C. 5324	Structuring a financial transaction to evade transaction reporting requirements.
15 U.S.C. 78dd	Foreign Corrupt Practices Act of 1977. Payment of anything of value to any foreign official, foreign political party or candidate or "any other person where the American corporation knows or has reason to know the thing of value would be offered to a foreign official, foreign political party or candidate for foreign political office."
15 U.S.C. 78ff	Criminal violations of securities laws.
15 U.S.C. 78x	Criminal penalty provisions of securities laws.

451.300-9-11/9

Texas Department of Banking

Attachment "C"

A PROPOSAL
for
FDIC ASSISTANCE TO FAILING BUT SALVAGEABLE BANKS

OUTLINE OF THE PROPOSAL:

I. Background and Purpose
II. Structure of the Assistance
III. Advantages to the FDIC Insurance Fund
IV. Impact on the Financial Industry
V. Conclusions and Recommendations

BACKGROUND AND PURPOSE

The pace of bank failures appears to have peaked in 1988, but it also appears likely that 1989 will post a similar number of failures. One notable aspect of recent bank failures which differentiates them from failures earlier in the 1980s is the potential that many may have been prevented if only enough new capital could have been attracted to buy the necessary time for rehabilitation. Economic and other external factors have been and continue to be too volatile for new investors to be persuaded to invest in and take a chance on turning around a problem yet economically viable bank.

The FDIC has several tools at its disposal for handling failed banks. Among these are:

P&A	Purchase and Assumption
TAPA	Total Asset Purchase Agreement
SLAP	Small Loan Asset Purchase
DITAPA	Deposit Insured Transfer and Purchase Agreement
DITASLAP	Deposit Insured Transfer and Small Loan Asset Purchase

These methods work well and have been very effectively used by the FDIC to expedite favorable resolutions of fail*ed* banks. What is additionally necessary, however, is a means for saving fail*ing* banks. A "prop-up" mechanism is needed to assist a bank *prior* to failure. In a manner analogous to a life-threatening medical emergency, it is first necessary to stop the bleeding and stabilize the patient before a team of surgeons can perform reconstructive surgery enabling the patient to recover and be restored to health. For a bank, this means providing some form of assistance to achieve sufficient stability so that a new investor will invest new capital. If investors with capital to inject can be provided a level of comfort and can feel confident they are not chasing a lost cause, then the new capital can be put to use generating restorative earnings and offsetting the drag caused by the nonearning or low-earning "troubled" assets. The bleeding is, thus, stopped and the healing process can begin.

Section 13(c) of the Federal Deposit Insurance Act authorized the FDIC to provide financial assistance to a bank if necessary to prevent its closing or to lessen the risk to the insurance fund. Given the magnitude of problem situations which may potentially invade the FDIC's insurance fund, cost control is a paramount objective. Any method, however innovative, which minimizes the cost to the fund warrants serious consideration.

The crux of the dilemma appears to lie in the interpretation or perception of "proper use" of the FDIC's insurance fund. Proper use of the fund would appear to include providing prop-up assistance of the kind outlined in this proposal since it is inherently no more costly than resolution of a failed bank and it provides the potential for reducing the cost by addressing the problem of a failing bank at a time when rehabilitation is still a viable alternative.

STRUCTURE OF THE ASSISTANCE:

What follows is a general description of how an FDIC prop-up assistance transaction could be structured to satisfy the concerns of the insurance fund and the interest of the bank's depositors and customers and new investors.

1) Once a bank has been identified as a probable failure but still economically viable (failing but salvageable), the primary regulator/chartering authority would notify the FDIC in writing that financial assistance was necessary to prevent failure. Without such assistance, failure within the next 12 to 24 months would be probable.

2) The FDIC, the bank's board of directors and a potential investor would identify and agree upon a pool of "troubled" assets (primarily poor quality loans, other real estate and repossessed other assets) which would then be segregated on the bank's books.

3) The FDIC would provide a guaranty to the new investor which would limit the loss exposure on the "troubled" assets. The amount of the guaranty would equal the amount by which the "troubled" asset pool exceeded the existing equity capital and reserves of the bank prior to the assistance transaction. Expressed as an equation, FDIC's exposure would be:

Dollar volume of "troubled" assets
Less: Pre-assistance capital and reserves
Dollar amount of FDIC assistance guaranty

As soon as losses on the "troubled" assets exceed pre-assistance capital and reserve, the FDIC guaranty would be utilized to cover additional losses from the pool. If losses never exceed the aggregate of pre-assistance capital and reserves, the FDIC guaranty would never be called upon to advance funds to cover losses.

Depending on the unique circumstances of the applicant bank, the FDIC's assistance quaranty may/may not provide for some form of income maintenance on the "troubled" asset pool.

The FDIC's assistance guaranty would be conditioned on the following:

a) The guaranty would terminate after a specified period of time such as five years.
b) Executive management and the board of directors of the assisted bank would be subject to review and approval of the FDIC.
c) Losses (charge-offs) incurred on assets in the "troubled" asset pool would be subject to FDIC's pre-approval.
d) Losses incurred on "troubled" assets would first be offset against the pre-assistance capital and reserves and thereafter against the FDIC guaranty.

e) All collections and recoveries on the principal or book balance of the "troubled" asset pool would reduce the balance of the pool and also the FDIC's exposure under the assistance guaranty.

f) Income from low-earning assets in the pool would be reflected as income for the bank and would not reduce the FDIC guaranty. Instead, it would help alleviate the drag on earnings caused by the assets in the pool.

g) New capital from external sources would have to be injected to satisfy capitalization requirements of the regulatory agencies, e.g. sufficient to achieve a minimum acceptable level of capital and reserves.

h) If the FDIC guaranty contained an income maintenance provision relative to the assets in the pool, the FDIC would be entitled to some form of equity participation, i.e. an equity "kicker". The objective of this equity kicker would be to replace the monies provided by the FDIC for income maintenance and to compensate the insurance fund for the foregone revenues which would have otherwise been earned on the monies.

EXAMPLE

For the purposes of illustration, assume that we have an economically viable bank that happens to be in a failing condition. After elimination of all known losses, the bank's balance sheet would look like this:

"Before" FDIC Assistance

Cash		10	80	Deposits
Securities		12	14	FF Purchased
Loans	68		2	Other Liab's
Reserves	(4)	64		
FF Sold		1	96	
BH & Equip		5		
ORE and OA		6	4	Equity Capital
Accr. Interest		2		
		100	100	

Now assume further that the FDIC, the board of directors and a potential new investor have agreed that 20% of all assets are "troubled" assets (primarily poor quality loans, other real estate and repossessed other assets) and that a fully funded loan loss reserve would require a balance of 6, thereby reducing equity capital to only 2.

Given this set of real-life circumstances, a potential investor would need to inject 4.2 of new capital to satisfy regulators' concerns for minimum acceptable capitalization. Combining the 4.2 of "new" investor capital with the remaining "old" equity capital of 2 would result in restructured total capital of 6.2 The bank would now have an equity capital-to-assets ratio of 6.0% on new total assets of 102.2, and the amount of the FDIC assistance guaranty would be 12 (i.e. troubled" assets of 20 minus the 4 of pre-assistance capital and the 4 of pre-assistance reserves). The segregated and restructured "new" balance sheet for the bank, after FDIC assistance, would now look like this:

"After" FDIC Assistance

Cash		10	80	Deposits
Securities		12	14	FF Purchased
"New" Funds		4.2	2	Other Liab's
"Good" Loans	54			
Reserves	(1)	53	96	
FF Sold		1		
BH & Equip		5		
Accr. Interest		2	2	"Old"Equity Capital
"Troubled" Assets	20		4.2	"New" Investor Capital
Reserves	(5)	15	6.2	
		102.2	102.2	

ADVANTAGES TO THE FDIC INSURANCE FUND:

The overriding advantage to the FDIC insurance fund appears to be the cost containment/cost minimizing feature of the proposal. By providing this assistance to an open bank which is still in an economically viable condition, the cost to the insurance fund would be minimized:

- by the amount of operating losses which would otherwise be incurred until ultimate failure of the bank;
- by the amount of discount the marketplace normally applies on otherwise performing loans acquired under a TAPA arrangement;
- by the amount of discount the marketplace normally applies on the remainder of bank assets acquired under a TAPA arrangement (i.e. bank premises, depreciated securities, data processing equipment or leases, etc.)

A second advantage to the GDIC insurance fund as a result of utilizing this proposal is that the bank would be recapitalized by either new management or by management acceptable to the FDIC (such as if existing management were not considered to be part of the problem causing the bank to be in a failing condition). In either case, new capital would be injected into the banking industry, thereby preserving ahd potentially enriching the insurance fund.

IMPACT ON THE FINANCIAL INDUSTRY:

The impact of the FDIC providing 13(c) assistance to an open, going-concern bank as it relates to the overall financial services industry appears twofold:

1) A private sector, market-dictated solution would be employed for failing banks which would --
    - allow the bank to retain its independent bank status, or
    - facilitate the merger of an existing bank with available "excess" capital with a failing bank in need of capital, and
    - provide old shareholders with some upside potential which would be negotiable with the new investors independent of the FDIC.

2) New capital and ultimately a foundation for economic recovery would be provided for economically depressed areas which would otherwise suffer the inevitable adverse credit consequences of a failed bank scenario.

CONCLUSIONS AND RECOMMENDATIONS:

The proposal outlined herein appears to deserve serious consideration as a cost-effective/cost-reducing plan for handling survivable problem banks through an FDIC-enhanced, private sector driven solution. Obviously, there may be numerous additional details in need of resolution to fully implement the proposal; however, the concept appears valid, appears in agreement with the spirit of the authority granted to the FDIC for providing assistance, and appears necessary to attract private sector capital to take the pressure off the FDIC insurance fund.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

January 12, 1990

Dear Mr. Chairman:

We are pleased to respond to follow-up questions to my testimony of October 25, 1989 on the Condition of the Banking System.

Enclosed is a listing of those questions together with our answers.

With best wishes.

Sincerely,

L. Wm. Seidman

L. William Seidman
Chairman

Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D. C. 20510

Enclosure

Questions submitted by Chairman Riegle

Q1. Mr. Kenneth Littlefield, Banking Commissioner for Texas, spoke persuasively in our October 17 hearing, about a new forward-looking, flexible system of examination and supervision in Texas. One element in this approach is concentration on "leading indicators" of condition (such as, high growth rates or dramatic changes in portfolio composition, management objectives or procedures). A second aspect is flexibility in examination and supervision. An experienced examiner is given a portfolio of banks to monitor continuously off-site rather than examine on-site periodically according to a fixed schedule. A third part is a system for evaluating management capabilities and performance.

Does the FDIC favor this approach? Has it adopted, or does it plan to implement the approach? If so, when? If not, why not?

A1. The FDIC's supervisory approach has been developed over the years into a program of using on-site examinations and visitations complemented with off-site activities. Today's banking environment demands that we identify emerging trends with potential areas of risk and pinpoint individual banks with symptoms of higher than normal risk.

FDIC personnel utilize quarterly performance reports on all insured banks to pinpoint emerging problems and unfavorable trends. This information is used to make adjustments to the on-site examination schedule. The success of this program is demonstrated by its widespread use, not only by the FDIC, but also by other federal bank regulatory agencies, numerous state bank regulators, private bank industry analysts and by the banks themselves for valuable tracking, comparison and planning purposes. Presently, on-site examinations are scheduled by Field Office Supervisors based on quarterly performance reports, prior examination findings, and monitoring of bank conditions through review of correspondence and press coverage. The Field Office Supervisor is responsible for the banks in the geographic area of the field office and has the flexibility to schedule on-site examinations or visits to the institution to investigate specific concerns.

Our experience has indicated, and we feel strongly, that on-site examinations cannot be eliminated in favor of monitoring systems. Concern for a realistic independent evaluation of the banking system led us in 1988 to adopt more frequent time frames for on-site examinations. The cooperative use of verifying on-site examinations with consistent analytical monitoring has proved most useful. However, total reliance on off-site monitoring would put too much emphasis on the institution's willingness and ability to recognize pending problems.

In many respects, Commissioner Littlefield's approach is an adaptation of refinements that the FDIC has been making to the examination process for some time. The FDIC is always pursuing better ways to become more effective supervisors. For example, we are currently in the process of developing a regulation that requires banks to report any plans for rapid growth. We have updated our examination manual to make it clear that evaluations are not to be based merely on an institution's present situation, but also where it is likely to be going. Our offsite review program has been expanded to monitor and track banks' growth over both long and short periods of time and to flag for additional review, banks which have unusual growth characteristics.

The evaluation of management that Commissioner Littlefield spoke of is one of the key aspects of the FDIC's examination process. We frequently review our examination policies, including those related to evaluating management and we received and commented on Commissioner Littlefield's system for evaluating management. We found it to be a useful and valuable tool. While similar to our own system for evaluating management, this system did provide us with some additional material and guidance which has been added to the information we provide our examiners on this subject.

Q2. Issuing a capital directive to an undercapitalized institution is one way to express your agency's concern over capital adequacy. Please state the number of capital directives issued by your agency in the last three years, and indicate the number and percentage of the current caseload of problem institutions that have received a formal capital directive. Please explain the general policy and procedural requirements for your agency's issuance of capital directives. Can your agency use capital directives to prevent future insolvencies?

A2. The FDIC has found that insufficient capital is rarely the only cause for concern in a problem situation. Instead of capital directives, the FDIC generally uses more comprehensive corrective actions that address all of the key shortcomings of a troubled financial institution. These comprehensive actions may take the form of acceptance of a resolution from the institution's board of directors, a memorandum of understanding between the FDIC and the institution or a formal administrative order issued under authority of Section 8 of the FDI Act. All of these actions normally include provisions for augmentation or maintenance of capital. In addition to capital provisions, it is common for these actions to address improvement in asset quality, proper reserving for potential asset losses, correction of violations of laws and regulations, implementation of a plan to achieve or enhance profitability, and adoption of appropriate policies and procedures.

In the three year period ending 12-31-88, the FDIC entered into 929 formal enforcement actions and 1,276 memoranda of understanding. The comprehensive programs are considered better suited to meeting all the problems of an institution and encompass the benefits of capital directives.

As of November 22, 1989, there are 1,161 banks on the FDIC's "Problem Bank List," of which 590 are insured state nonmember banks supervised by the FDIC. Of that number 240, or 41 percent, are subject to a formal administrative action to correct deficiencies. Almost all of the rest have a memoranda of understanding or other appropriate corrective programs in place. Informal agreements are frequently used when management is considered able and well-intentioned. These agreements are not subject to the lengthy time processes of formal cease and desist orders and capital directives and thus can be more efficient. Some problem institutions are subject to state mandated corrective actions to which the FDIC often has deferred or are subject to forbearance in capital maintenance or deferral of loan losses since the capital shortage was caused by economic problems and an acceptable capital plan has been generated by the institution.

The goal of any corrective action is to return the bank to a viable condition and prevent insolvencies. The various enforcement actions available to the FDIC including capital directives are considered valuable tools in this effort and will continue to be utilized in the future as appropriate to the situation at hand.

Q3. The savings and loan industry was decimated by losses on loans secured by real estate. Many of these loans were nonrecourse loans with high loan to value ratios. Real estate lending by banks has increased dramatically in the last five years. It has been argued that any problems associated with real estate lending by banks would be better addressed by regulation not legislation. What steps are you taking to prevent unsafe and unsound real estate lending, and specifically, what regulatory initiatives do you have planned to deal with the risk of real estate loans with high loan to value ratios? Several large Southwestern and New England banks have established surprisingly large loan loss reserves for real estate loans. Have real estate losses been adequately addressed by the banks in your jurisdiction or will there continue to be future surprises?

A3. We agree that the major problems in the area of real estate lending can best be addressed by proper supervision and regulation and not by legislation. The FDIC has long been cautioning banks against the hazards of imprudent real estate lending. Due to the rapid growth of real estate loan portfolios and the recent softening of individual markets, real estate lending activities are receiving heightened attention during on-site examinations as well as off-site monitoring and special reviews. We continue to monitor real estate lending activities closely and our examiners remain critical of unsafe and unsound lending practices including, among others, high loan to value ratios; inadequate levels of equity interest on the part of borrowers; inadequate appraisal and re-appraisal standards or implementation; insufficient credit investigation; over-reliance on collateral values; insufficient analysis of cash flow projections; speculative lending practices; or geographic, industry, property type, or borrower concentrations. In addition to receiving ongoing attention as part of the on-site examination process, real estate lending activities have been the target of special reviews at a number of institutions.

Our off-site supervisory efforts have also been intensified to alert us to such potential problems as may be evidenced by rapid growth of real estate lending or other activities in individual institutions. Supervisory efforts are directed at correcting imprudent lending practices while insuring that institutions take steps to protect themselves against potential losses inherent in existing portfolios by maintaining adequate reserves and capital levels. Our efforts to prevent unsafe and unsound real estate lending practices continue to be carried out through the supervisory process. In particular, we have cautioned banks as to the risks and potential conflicts of interest in financing real estate investments of insiders. Our examiners are alert for such situations. We have provided banks with guidelines on real estate appraisal policies and our examination procedures include review of real estate appraisal standards and policies. In addition, a major regulatory initiative is now underway to draft interagency regulations relative to appraisal standards.

In recognition of declining market trends for residential as well as commercial properties, a number of institutions, including several large Southwestern and New England banks are making significant additions to loan loss reserves for real estate loans this year. While, in some instances, reserve additions have been driven by supervisory prodding, the need for such increases in reserves was not a surprise, as we have been warning banks against the potential risks inherent in their portfolios, especially in institutions with loan concentrations in softening markets. The likelihood of further declines in a number of markets implies some increase in nonperforming real estate assets, although the majority of banks are believed to have adequately identified existing problems. However, until the market for these properties has stabilized, some additional charge-offs may have to be realized. The FDIC is currently conducting a study of real estate markets around the country. One of its main goals is to assure that regulators and the financial industry do a better job of anticipating problems rather than reacting to them.

Q4. Do you believe that a definition of solvency based on the fair market value of a financial institution's assets and liabilities would promote the safety and soundness of the banking system?

A4. Fair market value evaluations do have appeal but the real world difficulties in implementing them in any fair and meaningful fashion are substantial. Using market values for the bond investment account might be a good place to start since pricing is rather well agreed on. One difficulty in adopting a full market value system is whether the volatility of values in such a system would promote or hinder safety and soundness. The uncertainty might be more disruptive than helpful, but substantial further study would be necessary. We note that the feasibility of market value accounting is one of the subjects to receive well deserved consideration in the FIRREA-mandated study of federal deposit insurance (Section 1001 (b)(4)). We will look forward to the results of that study.

We do not favor fundamental changes to current accounting and reporting practices at this time. To assign fair market values to all of a financial institution's assets and liabilities would be a time consuming, costly and difficult task, necessarily involving a great deal of data gathering and estimates. Moreover, the process would be ongoing with frequent updating to recognize changes in market values and the interest rate environment. It would introduce a questionable degree of subjectivity and volatility to financial reporting. We do, however, favor greater disclosure of more objective data to supplement existing financial reporting practices to enable analysts and other users to make their own judgments about the condition and prospects of particular financial institutions.

Much the same is true with regard to supervisory approaches to determining financial institution solvency. We believe that existing practices whereby an examiner determines on-site the collectibility of an institution's loans and appraises the value of its securities and other assets are sufficient for supervisory purposes, including determinations with regard to solvency and capital adequacy.

Q5. What improvements do you feel that you need to make in your system of regulation, examination, supervision, and enforcement? When do you plan to implement these improvements?

A5. Improvement in our system of regulation, examination, supervision, and enforcement is a continuous and on-going process in response to changes in the industry and our resources and experience. We currently, for example, perceive a need to better utilize our existing examiner force and, hence, are revising our approach to scheduling examinations and streamlining the methods and practices used to examine institutions presenting different risk profiles. We are continually refining and updating our offsite monitoring system to aid us in this endeavor.

We are also continuing to increase our examiner force and to expand and upgrade their training to enable them to better analyze and assess risk in such diverse areas as interest rate risk, highly leveraged transactions (HLT), capital market financial instruments and international investments and transactions. Initiatives in all of these areas are currently underway.

Q6. What actions and decisions that you now take independently would be better if coordinated with your fellow regulators?

A6. We take no actions or decisions independently that would be better coordinated with our fellow regulators. Whenever we perceive that coordination is necessary or desirable, we do in fact coordinate with our fellow regulators by exchanging information and views in an attempt to reach a consensus or common approach. This is not to suggest that our efforts are necessarily always successful as the current controversy over capital standards aptly demonstrates. Nevertheless, this result is not for lack of trying or coordination.

Q7. Recently, several money center banks have substantially increased their loan loss reserves. Are the loan loss reserves held by U.S. banks against their LDC loans adequate? Will you require/encourage banks to increase the reserves they hold against LDC loans? Or will you discourage them? What impact will the increase in reserves have on the Brady Plan?

A7. As a group, the money center banks have substantially increased their loan loss reserves since the second quarter of 1987. During the third quarter of 1989, the nine money center banks added over $6 billion to their loan loss reserves, bringing average LDC coverage up to 52 percent of medium and long-term outstandings for the group. Individual bank coverage ranges from 29 percent to 97 percent of such exposures among the group.

We support efforts made by banks to increase their general loan loss reserves, as well as efforts to increase their equity capital levels as a means of strengthening their position relative to their international loan portfolios. The assessment of reserve adequacy is unique to individual institutions and encompasses a variety of factors, including the individual bank's strategy relative to future LDC lending, equity capital levels, availability of the entire loan loss reserve (not just that which is earmarked for LDC coverage), and access to capital markets. We do not mandate specific levels of reserves other than the Allocated Transfer Risk Reserve required for certain protracted situations, as outlined in the International Lending Supervision Act of 1983. The setting of general reserve levels for an individual institution is a decision to be made by bank management, based on an assessment of the risks inherent in the institution's loan portfolio. We, of course, do review the adequacy of these judgments and at this time are not recommending any significant additions. This matter is subject to regular review. As a group, it is our opinion that the money center banks appear able to withstand any foreseeable write-downs of their LDC portfolios from existing LDC reserves.

Increased levels of reserves on the part of a number of banks would afford a greater degree of flexibility with respect to participation in the Brady Plan and, in particular, any exit bond type arrangements. A possible scenario which can be drawn from the increase in reserves is an inclination by the banks to exit LDC lending via such arrangements, rather than to participate in the new money option, as outlined in the Brady Plan.

Q8. Are you comfortable with: (a) the loan underwriting capacity of the banks that purchase portions of the senior debt that is originated by the large banks in LBO and other highly levered transations; (b) currently applicable accounting principles that govern how banks book the commitment and other fee income associated with their origination of LBO and other highly leveraged transactions; (c) the methods banks use to determine their provisions for loan losses on LBO and other highly leveraged transactions; and (d) data availability on LBOs? What steps are you taking to remedy any deficiencies?

A.8 (a) Multinational banks originate the preponderance of HLT loans. These banks lessen their level of exposure by selling significant portions of these loans shortly after origination. Some HLT loans are drifting into the regional and smaller banks. There are some exceptions, but generally the smallest banks have not acquired HLT concentrations. Banks that do not have the expertise to conduct in-house independent credit analyses of HLTs should not be buying participations in such transactions. This includes the vast majority of small banks and some regional banks. Potential purchasers must not rely on the seller to perform the analysis for them -- especially because sales are made without recourse. In May of this year we distributed to our examiners and the chief executive officers of FDIC-supervised banks examination guidelines for HLT transactions. Strict adherence to the guidelines should assure that acceptable underwriting standards are maintained. To date our examiners have not uncovered a significant number of instances wherein participations were purchased on an unsound basis.

(b) In most instances we are reasonably comfortable with the accounting treatment applied to HLT transactions. However, in those instances wherein the HLTs take on more of the characteristics of equity rather than senior debt, and interest payments are not supported by earnings, the accrual of such interest income by the lender seems inappropriate. In these cases, the lender is in essence receiving back principal while collateral protection is eroded and interest should be deferred.

(c) The methodology employed varies from bank to bank on how HLT activity is factored into determining the adequacy of loan valuation reserves. Banks that have a concentration in HLT transactions or participate in the riskiest segments of HLT lending, are expected to specifically address HLT lending in assessing the overall adequacy of the reserve. For the most part, we are reasonably satisfied with the level of loan loss reserves at most of the banks involved in HLT lending.

(d) The amount of data collected and its reliability has been a problem. A major problem has been inconsistency in reporting by institutions due to lack of a uniform definition. The definition problem was overcome in October of this year by adoption of a uniform definition of an HLT by the three Federal banking agencies. HLT data was developed through the Shared National Credit Program conducted in the spring of 1989 and the figures are generally reliable. Better numbers will be forthcoming in the future as the uniform definition is applied.

Q9. The recent S&L legislation enables the FDIC to force one bank in a holding company to reimburse the FDIC for the losses caused by another, failing member. Some people ask if this provision is equitable. I understand that two cases have already occurred where this provision has been relevant. Are you satisfied with the way this provision is working? Do you expect to have problems with its implementation?

A9. The results have been mixed in the two cases in which we have attempted to utilize the cross-guarantee provisions of the FIRREA. We nonetheless believe these provisions represent a valuable tool for helping to resolve failed and failing bank situations and minimizing our costs and are working as planned when they were orginally suggested. In one case, we were able to arrange for the recapitalization and independence of a deteriorated bank affiliate by waiving a cross-guarantee assessment. Although no immediate recovery was obtained, the result prevented a probable future loss to the FDIC. However, in the other case, the stock of a failing institution was acquired one day in advance of closure by a lender for debts previously contracted, effectively removing the institution from the cross guarantee provisions of FIRREA and preventing the planned assessment. It is also possible for a holding company that is aware that one or more of its subsidiary institutions is having problems and is in danger of failing, to sell its good institutions and thus transfer the value of those good institutions to the holding company and remove their value from the cross guarantee provisions of FIRREA.

To the extent there are problems or potential abuses, we will be proposing amendments to make it more effective.

Questions submitted by Senator Garn

Q1. Are you concerned that there may be an over concentration of real estate lending in some sections of the country? Where are these concerns most aggravated? Do you believe that over concentration in any one economic segment creates risks for our financial institutions? Do you believe that it was a mistake to impose a 70 percent QTL test on thrift institutions? Do you believe that the QTL test will make it more expensive to resolve the problems in the thrift industry?

A1. Domestic real estate portfolios have been experiencing rapid growth, particularly among the largest institutions, with outstandings increasing by 12.8 percent on average for all U.S. commercial banks for the year ending June 30, 1989. Rapid growth is a concern as, in many cases, it is accompanied by declining credit quality. Whenever it occurs, the combination of accelerated portfolio growth and simultaneous credit quality deterioration is of particular concern. The Northeast region of the U.S. has been experiencing rapid real estate growth; at the same time, the percentage of noncurrent loans in the portfolios has increased, while net charge-offs have likewise been trending upward.

High levels of noncurrent loans and net losses continue to characterize many of the real estate portfolios in the Southwest region. The Southeast region has the highest concentration of real estate loans as a percentage of commercial bank loan portfolios, however, noncurrent loans and net losses remain at manageable levels.

While geographic concentrations, in and of themselves, need not necessarily be problematic, other factors, such as concentrations among industry, borrower, or property type may contribute to portfolio problems in areas where real estate markets are depressed. Such factors become even more troublesome in institutions which do not have adequate underwriting standards.

The 70 percent QTL test on thrifts may require a concentration of asset risks and thus carries with it a potential for problems, particularly in a volatile interest rate environment. While a 70 percent QTL test may have some positive effect in reducing credit risk, it may well have negative implications for profitability, as a 70 percent QTL test may limit thrifts' ability to react to fluctuating interest rates. While it is possible to sustain profitability in a volatile rate environment, the maintenance of the suitably matched position needed to do so becomes increasingly more important. Potential difficulties in attaining desired levels of profitability may very well increase the costs of resolving thrift industry problems.

Q2. Many of the problems in the thrift industry may be traced to excessive powers granted these institutions by the States, starting in 1980. However, unlike recent proposals in the Senate to pass comprehensive powers legislation for holding companies, the States permitted the institution to engage in the new activities directly. Do you believe that Congress should provide banking institutions with new powers? In what areas would you recommend legislation? What structural safeguards would you propose to safeguard the deposit insurance system from the risks that might be presented by new products and services?

A2. These issues have been addressed comprehensively in our 1987 study "Mandate for Change - Restructuring the Banking Industry." A copy of that study is submitted herewith for the record. In general, we favor a variety of additional powers to be lodged in separately capitalized bank subsidiaries, holding companies, or nonbank affiliates within a holding company structure, but with appropriate "firewalls" designed to protect an insured depository institution from excessive risk, undue reliance on insured funding, conflicts of interest and self-dealing. Activities judged to be excessively risky should not be authorized for insured depository institutions.

Q3. One of the basic principles behind the recently enacted savings and loan legislation was that the deposit insurance function and chartering function should not be contained in the same agency. However, a potential conflict also exists between the insurance function and regulatory function, since it is to a regulator's advantage to have as many institutions as possible within its jurisdiction. Do you agree that a potential conflict exists between the insurance and regulatory functions? Would you recommend that the FDIC's regulatory functions be split off from its insurance functions, so that it becomes a pure insurance agency?

A3. We perceive no conflict between the insurance and regulatory functions and indeed regard these as complementary since both are concerned with the safety of insured institutions. The insurer should have whatever regulatory authorities are necessary to protect the soundness of the insurance fund. Assessing and containing risk is an essential part of every insurance operation, whether public or private, and regulation is one means of helping to contain risk in insured depository institutions. The only potential conflict is that the insurer may be "too conservative" in its supervision. This possible over-conservatism may be useful based on recent experience.

Q4. Do you believe the examination force of your agency is sufficient to closely monitor the conditions of banks within your primary jurisdiction? What percentage of such institutions are examined on a yearly basis? On a bi-yearly basis? Less frequently? Do you believe it would be prudent to increase the frequency of bank examinations?

A4. We have had some concerns regarding examination frequency during the past years and have reacted in three ways to address these matters. First, we have recognized the need to maintain our traditional on-site examination focus and have shortened the maximum time between examinations. Institutions with a CAMEL rating of 1 and 2 are to be examined at least once every 24 months and all other institutions are to be examined at least once every 12 months. Flexibility is available to make short term visits to investigate general matters or specific problems or to accelerate the examination schedule as concerns surface through our comprehensive offsite monitoring system. This policy also uses examinations performed by state banking departments, especially for those institutions rated 1 and 2. Second, we have seen the need to increase our force of examiners. At year-end 1988, we had 1,983 field examiners. This is an increase from 1,389 five years earlier. We intend to further increase this valuable work force to 2,400 within the next year. Third, we recognize the need to provide adequate training for our examining force. This training is highly specialized and we find we are most successful in performing the bulk of the training on the job and in our training center.

The attached table shows state nonmember commercial and savings banks with examinations or visitations by the FDIC and State authority completed or in process as of June 30, 1989. This table illustrates our examination frequency over time. The requested bi-yearly breakdown for 3-, 4- and 5-rated banks is not readily available. However, all 3-, 4- and 5-rated banks with examinations over one year old are closely monitored and in almost all cases have had an examination within a two year period.

Q5. Is there any indication that the small, well-capitalized banks which will not have trouble meeting the risk-based capital standards will see a new leverage ratio as an opportunity to reduce the capital in their institutions? Have these institutions reduced capital in the past when capital standards were changed?

A5. Yes, we believe many banks would see a new leverage ratio as an opportunity to reduce capital ratios. The present minimum capital level of 6.0 percent was set for sound, well-managed banks without significant problems, but our efforts to require increased capital in problem situations has usually been met with resistance. Banks evidencing more than normal levels of risk have minimum capital requirements established in a formal or informal supervisory proceeding, almost always at levels higher than the general minimum. The level of effort required to achieve bank compliance with the existing regulation convinces us that if the standard were decreased, many banks would allow their capital to be eroded to lower levels. Today's banking environment provides more opportunities than ever for growth through new branching opportunities, interstate banking, and the exercise of new powers. Smaller banks have traditionally maintained higher capital levels which exceeded the regulatory minimum. We would expect them as a group to continue to do so but at a lower level. In this difficult time in the financial services industry, we are convinced that lowering capital standards would be counterproductive. In our unique role as insurers of the nation's deposits we view capital as a buffer between potential losses and the insurance funds and we are convinced that lowering the leverage requirements would increase the potential for risk to the funds.

The first minimum capital levels established by law or regulation became effective in 1985 (the FDIC adopted Part 325 of the FDIC Rules and Regulations to implement those capital requirements). Prior to that time capital levels were maintained based on persuasion and supervision by the regulators. Since the establishment of a regulatory minimum, FDIC efforts have been focused on bringing deficient institutions up to the prescribed minimum and insuring that other institutions do not allow their capital to be dissipated below the minimum. The Comptroller's present proposal to lower capital minimums is the first time that the minimum set by regulation would be reduced. Attached is a copy of our recent letter to the Comptroller commenting on his proposed regulation.

Q6. In your testimony you state that "some deterioration" is expected in the state-chartered savings banks. Do you expect that a significant number of these institutions could fail or be forced to merge to avoid failure?

A6. Some deterioration in the condition of the state-chartered savings banks has been seen. In view of the trend toward higher levels of problem real estate assets, particularly in the Northeast, operating performance may deteriorate. Net interest margins may be squeezed by higher nonperforming assets, while some increase in loan loss provision expense is also probable. We do not see any significant number of these institutions failing or being forced to merge to avoid failure in the foreseeable future. However, we do expect at least a few cases to require FDIC financial outlay.

Q7. Will thrifts have difficulties meeting the new qualified thrift lender test in the softening real estate markets of the northeast and southwest?

A7. Estimates indicate that approximately 74 percent of existing thrifts would pass the new qualified thrift lender test, based on data available as of June 30, 1989, while roughly 26 percent of thrifts would fail. Although a geographic breakdown of failures is not readily available, a large portion of institutions failing to meet the new criteria are located in the Southwest. The number of Southwest institutions failing to meet the new standard is expected to decline, however, due in part to probable closings. While softening markets in the Northeast may contribute to an increase in thrifts located in these markets failing to meet the new test, the extent to which real estate market conditions will play a role is uncertain.

A.4

06-30-89
EXAMINATION/VISITATION REPORT AGING SCHEDULE
STATE NONMEMBER COMMERCIAL AND SAVINGS BANKS
EXAMINED BY FDIC OR STATE AUTHORITY

	1- AND 2- RATED BANKS					3-RATED BANKS			4- AND 5-RATED BANKS		
REPORT DATES	NUMBER BANKS	EXAMS 2-3 YRS OLD		EXAMS 3 YRS OLD		NUMBER BANKS	EXAMS OVER 1 YEAR		NUMBER BANKS	EXAMS OVER 1 YEAR	
		#	%	#	%		#	%		#	%
06-30-88	6,269	512	8	384	6	1,151	299	26	752	151	20
09-30-88	6,238	432	7	223	3	1,117	211	19	712	91	13
12-31-88	6,166	379	6	170	3	1,117	213	19	686	83	12
03-31-89	6,229	365	6	124	2	1,121	205	18	525	80	15
06-30-89	6,210	337	5	121	2	1,114	192	17	534	58	11

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Bank Supervision

January 4, 1990

Ms. Jacqueline England
Office of the Comptroller
of the Currency
Docket Number 89-14
Communications Division, 5th Floor
490 L'Enfant Plaza East, S.W.
Washington, D.C. 20219

Dear Ms. England:

We appreciate the opportunity to respond to the OCC's request for comment on its November 3 proposal to revise the existing national bank leverage standards. Although our comments do not represent an official position of the FDIC Board of Directors, they nonetheless provide the views of the FDIC's Division of Supervision.

The OCC proposal would replace the existing 5 1/2 percent primary and 6 percent total capital leverage ratios with a new leverage standard that requires a minimum core capital to total assets ratio of 3 percent. This revised leverage standard would become effective on December 31, 1990, the date on which a minimum risk-based capital standard first becomes effective.

We support the establishment of a minimum core capital requirement under a revised leverage standard. However, the 3 percent core capital constraint, in our view, should only be viewed as a subtest. That is, we believe a revised leverage standard should set forth a minimum total capital requirement over and above the OCC's proposed 3 percent core capital requirement. This additional capital could be comprised of secondary sources of capital, similar to the manner in which the risk-based capital guidelines require both a minimum core capital standard and a higher minimum total capital requirement.

We believe an additional amount of capital over and above the OCC's proposed 3 percent core capital minimum is appropriate for the following reasons:

(1) The great majority of banks meet the existing 6 percent total capital leverage requirement with a combination of common equity capital and the allowance for loan losses. The proportion of the existing leverage ratio that is comprised of the allowance for loan losses usually does not amount to more than 1-2 percent of total assets. That is, in meeting the existing leverage standard, most institutions presently have a minimum of 4-5 percent in capital exclusive of the loan loss allowance.

with the OCC's proposal, the minimum amount of common equity capital (as well as total capital) that these institutions would need to maintain under a leverage standard would fall to 3 percent. In view of the risks to which banks are exposed, many of which are not factored into the risk-based capital framework, we believe that any revised leverage standard should not materially lower the minimum leverage requirements presently applicable to banks.

(2) Given the existing capital structures of most banks, the present 6 percent leverage standard generally requires a larger dollar amount of capital than that required under the new risk-based capital guidelines. Based on our estimates, the amount of total capital (including loan loss allowances) that the median bank would need to maintain under the risk-based framework, when converted to a leverage ratio equivalent, would only amount to approximately 5 percent of balance sheet assets, only one-half of which would need to be core capital. This is the estimated risk-based capital requirement for the median bank — that is, one-half of the banks would have even lower capital demands under the risk-based requirements.

Further, once banks begin to more aggressively manage their financial positions to minimize the impact of risk-based capital, the minimum amount of capital required under the risk-based framework could fall even further. In this regard, there has already been increased emphasis by some banks on investments in certain assets that have low risk weights under the risk-based framework but which are still relatively illiquid. These include certain investments in privately-issued, mortgage-backed securities that are collateralized by GNMA securities and therefore assigned to only a 20 percent risk weight. These and similar investment decisions by banks can significantly reduce the minimum risk-based capital requirement without materially improving a bank's overall financial condition or interest rate risk position.

In view of these concerns, we believe that any revised minimum leverage capital standard should not be allowed to materially reduce the minimum capital requirements for any institution. Rather, the risk-based framework should function primarily as a vehicle for ensuring that certain banks (e.g., those with significant off-balance sheet risks) maintain additional capital over and above a prudent leverage standard. That is, the leverage standard should remain a prominent part of capital standards and should not be relegated to a relatively obscure backstop role.

Risks in the banking industry over the past decade have increased as deposit interest rate restrictions have been lifted and as competition has intensified. Many of these risks are not specifically captured in the risk-based capital framework. As a result, we believe that any revised leverage standard should be maintained at a level that, in substance, is at least as stringent as the existing 6 percent standard. Assuming the allowance for loan losses is excluded from total capital for purposes of a revised leverage standard, we believe that the minimum leverage standard for the great majority of banks should be at least in the 4-5 percent range.

Based on our estimates, most of the institutions that could maintain less capital under the proposed OCC capital standards than under the existing leverage standard are banks already recognized as supervisory problems. Thus, we feel that some additional leverage constraint over and above the 3 percent core capital test is not only prudent in theory, but also supportable based on the facts.

If the OCC ultimately decides to adopt the 3 percent core capital ratio as the sole minimum leverage standard, we believe the standard should specifically indicate that such a minimum will only apply to the most well-run institutions that have very high asset quality, minimal interest rate risk and that have composite CAMEL ratings of 1 under the FFIEC's Uniform Financial Institutions Rating System.

Thank you for this opportunity to comment on the OCC's proposed revision to its capital regulations.

Sincerely,

Paul G Fritts

Paul G. Fritts
Director

cc:

Mr. Robert L. Clarke
Comptroller of the Currency

Mr. Dean Marriott
Senior Deputy Comptroller
Office of the Comptroller
of the Currency

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

January 23, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D. C. 20510-6075

Dear ~~Mr. Chairman~~ Don:

Enclosed are answers to the followup questions to my testimony before the Committee on Ocotber 25, 1989. Thank you for this opportunity to elaborate on the testimony.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

Enclosure

QUESTIONS FROM SENATOR RIEGLE

1. The OCC's number of examiner manhours per $100,000 of deposits has fallen sharply in recent years, even after adjustment for inflation. Are you satisfied that you are fully meeting your examination and supervision responsibilities?

A. We are satisfied that the OCC is meeting its examination and supervisory responsibilities. The ratio of examiner hours to $100,000 of deposits has fallen by two percentage points since 1985, but during my tenure as Comptroller of the Currency the number of hours devoted to supervising banks has increased by 28 percent. During this period there has been significant consolidation among national banks. There are economies of scale in supervising banks, and, therefore, it is not surprising that the ratio of examiner hours per volume of deposits has fallen.

Nonetheless, I must point out that the number of examiner hours per dollar volume of deposits is an inadequate measure of the effectiveness of our supervisory efforts. Rather, one must focus on how resources are deployed. One of the OCC's most important accomplishments in recent years is the change we have made in how we allocate our resources.

We focus the bulk of our resources on the banks that pose the greatest risks to the banking system--the largest banks and those with the most severe problems. Under our approach, we determine the level of risk in each national bank and the potential impact that risk may have on the stability of the national banking system. We then assign banks to a hierarchy of risk and allocate supervisory resources accordingly.

The risk-oriented approach to bank supervision, which the OCC adopted in 1986, has had a substantial effect on our allocation of resources. An early 1980s estimate of our resource allocation found that the OCC spent 80 percent of its supervisory resources in banks that held 20 percent of total bank assets. Although that meant that oversight of small institutions was good, it represented an inefficient allocation of resources. Only 20 percent of regulatory time was available for supervising banks that had 80 percent of national bank assets. Today, 70 percent of OCC time is spent supervising areas that represent the greatest risk to the banking system. Only 30 percent of our examiner resources are spent on community banks that are sound and well-managed or possess problems that are being addressed properly. Those institutions hold 12 percent of national bank assets.

Our current approach enables us to use our supervisory resources more efficiently. We seek to ensure that each national bank receives an amount of supervisory attention appropriate for the level of risk it assumes in its operations and the level of risk it poses to the banking system. We maintain a system of ongoing supervision of each national bank, which enhances our ability to identify emerging problems in individual banks and the banking system.

This approach ensures that we are able to meet our supervisory responsibilities and reallocate resources, as necessary, to meet changing conditions in the banking system.

2. During your testimony you stated that the proposed leverage ratio applicable to national banks would be "a leverage ratio equal to 3 percent of total assets, a ratio made up totally of hard capital, capital like stockholder equity, capital _in its most tangible form_" (emphasis added). We note that the core capital definition used for risk-based purposes includes intangible assets up to 25% of the requirement. Indeed, until FIRREA prescribed otherwise, the OCC definition of core capital would have allowed so-called "supervisory goodwill" to be included in a national bank's core capital. Does your testimony indicate that you intend to follow FIRREA's lead and make the leverage ratio a test of 3% tangible capital, instead of 3% core capital, to total assets? If not, please explain your reference to a capital standard that includes intangible assets as "capital in its most tangible form"?

A. The OCC's core capital definition is virtually identical to the tangible capital definition in FIRREA. The OCC's proposed minimum leverage requirement would require core capital to be at least 3 percent of adjusted total assets. Core capital consists of common stockholders' equity, noncumulative perpetual preferred stock, and minority interests in consolidated subsidiaries. Intangible assets are deducted from assets and, therefore, from core capital unless they meet specified criteria of marketability, separability, and identifiability. Those intangible assets that meet those criteria are restricted to 25 percent of core capital under the present definition. Any amount that exceeds that level is deducted from core capital. Purchased mortgage servicing rights (PMSR) are the only intangible assets that have been identified as meeting the specified criteria.

The OCC's definition of core capital and FIRREA's definition of tangible capital differ only in that FIRREA adopted a different limitation on the inclusion of PMSR: only 90 percent of the fair market value of PMSR may be included. Neither limitation is uniformly more stringent.

Regarding goodwill, the OCC's risk-based capital guidelines allow for the case-by-case inclusion of supervisory goodwill as an asset and, thus, as capital. Few national banks have any supervisory goodwill on their books, and the OCC has approved no supervisory goodwill for inclusion in capital.

3. You testified that you intend to change the standard for "closing banks" from insolvency on a primary capital basis to insolvency defined by "pure equity capital". Will the OCC appoint the FDIC as conservator for a national bank only after the bank is insolvent, or are there instances in which a bank, operating in an unsafe and unsound condition, would be placed in conservatorship even though it was solvent on the basis of Generally Accepted Accounting Principles?

A. As you noted, the OCC recently adopted a regulation under which we may declare a national bank insolvent and close it when its equity capital is depleted, rather than waiting until the allowance for loan and lease losses and other forms of primary capital are also exhausted. By statute, when the OCC closes insolvent institutions it places them in the hands of the FDIC as receiver. With respect to conservatorship, Title VIII of FIRREA enables the OCC to appoint a conservator for the bank for various reasons, including insolvency. Presently, we are exploring some technical questions involved in the use of our conservatorship powers.

Insolvency is only one of eight possible grounds for placing a bank into conservatorship set out in the amendments to the Bank Conservation Act contained in Title VIII of FIRREA. The other seven address circumstances that indicate that either insolvency is likely or that there are other threats to the condition of the bank. Thus, the legislation clearly contemplates that the OCC could place a bank that is solvent on the basis of Generally Accepted Accounting Principles (GAAP) into conservatorship.

Placing a GAAP-solvent bank into conservatorship would be fully consistent with the objectives of the Bank Conservation Act, i.e., conserving the assets of a bank to prevent or minimize losses to the insurance fund. As the OCC uses this new authority, we will be able to more specifically define those situations in which conservatorship would be the most appropriate supervisory response to a troubled, but still solvent bank.

4. Issuing a capital directive to an undercapitalized institution is one way to express your agency's concern over capital adequacy. Please state the number of capital directives issued by your agency in the last three years, and indicate the number and percentage of the current caseload of problem institutions that have received a formal capital directive. Please explain the general policy and procedural requirements for your agency's issuance of capital directives. Can your agency use capital directives to prevent future insolvencies?

A. A capital directive is a limited enforcement tool. It addresses only the inadequacy of a bank's capital. The objective of a capital directive is to focus the attention of a bank's managers and directors on the immediate need for capital. A capital directive cannot guarantee that the necessary capital will be raised. Therefore, a capital directive alone cannot prevent a bank from becoming insolvent.

The OCC has issued few capital directives. A troubled bank typically has a number of difficulties, which are usually addressed in a formal agreement or a cease and desist order. Since 1986, 584 national banks have been placed by the OCC under a formal agreement or an order to cease and desist. The great majority of those enforcement actions stipulate a minimum level of capital to be achieved and maintained by the bank.

During 1986 and 1987, the OCC issued no capital directives. One capital directive, which had been issued in 1985, was outstanding. In 1988, the OCC issued no capital directives, and none were outstanding. During 1989, the OCC issued three capital directives. Two of the banks that were subject to capital directives have failed, so currently one capital directive is outstanding. Fewer than one percent of the current caseload of problem banks are subject to a capital directive.

As a matter of policy, the OCC pursues a capital directive when capital is the single overriding concern in a weak institution and time is of the essence. In practice, there are three roads that can lead to a capital directive. First, a bank that falls below the minimum capital requirements (currently primary capital equal to at least 5.5 percent of assets and total capital equal to at least 6 percent of assets) and fails to file with the OCC an acceptable plan for getting back to the minimum requirements, or a bank that files an acceptable plan but deviates from that plan, may be issued a capital directive. Second, if the OCC requires a bank to maintain a level of capital that exceeds the regulatory minimums and the bank fails to do so, we may issue a capital directive. Third, a bank that consents to a formal agreement that deals with capital, or receives approval of a corporate application that contains conditions related to capital, and subsequently violates that agreement or condition, may be subject to a capital directive.

Procedurally, a bank does not receive a full evidentiary hearing prior to the issuance of a capital directive, but the OCC does solicit and consider the views of the bank. If one of the conditions described above exists, the OCC may send the bank a letter indicating its intention to issue a capital directive. That letter states what conditions have led to consideration of issuing a capital directive, describes what a capital directive would likely require, and offers the opportunity for the bank to respond in writing before a final decision is made. Once the response period has expired, the Supervision Review Committee in our Washington office reviews the case, including any response the bank may have made, and decides whether to issue a capital directive. When issued, a directive takes effect immediately.

5. The savings and loan industry was decimated by losses on loans secured by real estate. Many of these loans were nonrecourse loans with high loan-to-value ratios. Real estate lending by banks has increased dramatically in the last five years. It has been argued that any problems associated with real estate lending by banks would be better addressed by regulation not legislation. What steps are you taking to prevent unsafe and unsound real estate lending, and specifically, what regulatory initiatives do you have planned to deal with the risk of real estate loans with high loan-to-value ratios? Several large Southwestern and New England banks have established surprisingly large loan loss reserves for real estate loans. Have real estate losses been adequately addressed by the banks in your jurisdiction or will there continue to be future surprises?

A. We agree that legislation is not the answer to today's real estate lending problems at banks. We believe that those problems are most appropriately addressed through supervisory initiatives. Accordingly, the OCC has taken a number of steps in response to the growth in real estate loans by national banks and the rise in the percentage of those loans that are nonperforming. Our examiners have specifically targeted the real estate lending practices of national banks in regions where there is evidence of softening real estate markets or unsound lending practices. Where we have found banks that have high real estate credit exposures and weak or inappropriate systems to control and manage their exposures--including inadequate reserves--we have directed them to take appropriate corrective action. And we have issued advisory notices to all national banks highlighting both our concerns about increased real estate credit exposure and our examination findings that some banks have failed to follow sound principles in making real estate loans and monitoring their performance.

For example, in the spring of 1988, the OCC conducted an extensive review of real estate lending policies and practices at regional banks in the southeast which was then exhibiting the first signs of a softening real estate market. Inadequate lending policies or discrepancies between policies and actual practices were brought to the attention of senior bank managers for corrective action. Similarly, in 1989 the OCC conducted targeted examinations of banks with large real estate portfolios in the softening New England market. Targeted real estate examinations at banks in the northeast are continuing in 1990. As we see the results from these examinations, we will determine whether loan loss reserves and policies and procedures are adequate. If they are not, we will take corrective action.

To help examiners target the most serious problems, the OCC recently developed a real estate valuation model which simulates the effect of a downturn in real estate markets on bank equity capital. The model will be used by examiners to identify vulnerable banks or to analyze the capital adequacy of a particular bank. The OCC is sharing the model with other bank supervisory agencies and working with them to ensure the sharing of relevant data on bank real estate holdings and underlying market conditions.

We believe that our approach is superior to statutory constraints, such as restrictions on loan-to-value ratios, that address loan quality at the inception of the loan, but do not account for changes in market conditions after a loan is made. Our focus on managements' systems and policies and procedures is aimed at ensuring that management in the bank, as well as the OCC, is well-informed of the risks in the system and that appropriate corrective action is taken when shortcomings exist.

Going forward, we will continue to monitor trends in real estate markets and bank exposure to real estate loans. We are paying particular attention to some commercial real estate markets in the northeast, southeast, and west that have experienced sharp increases in their vacancy rates. Although weaknesses in those markets do not appear at this time to be as severe as they have been in the southwest, many national banks have significant commercial real estate loan exposures, and some have experienced rising levels of nonperforming real estate loans and real estate loan charge-offs. As we stated above, we are requiring banks to take a hard look at their real estate loan portfolios and will require additional provisions to loan loss reserves where severe weaknesses in local real estate markets have impaired credit quality. In this regard, a large New England bank recently made a significant addition to its loan loss reserve because of weakness in its real estate lending portfolio.

6. Do you believe that a definition of solvency based on the fair market value of a financial institution's assets and liabilities would promote the safety and soundness of the banking system?

A. In theory, it would be desirable to measure bank solvency on the basis of the fair market value of all of a financial institution's assets and liabilities. In practice, that is often difficult to do. Some assets, including many securities held by banks, are actively traded in organized securities markets. Determining the market value of actively traded securities is a relatively straightforward matter, and the OCC requires banks to value their trading account assets at market value. There are not, however, organized markets for trading many other bank assets, including most commercial and consumer loans. Thus, there is no generally recognized method for determining a fair market value of such assets. Similarly, because of the absence of organized markets, it would be difficult to determine the market value of certain bank liabilities, such as non-negotiable certificates of deposit.

7. What improvements do you feel that you need to make in your system of regulation, examination, supervision, and enforcement? When will you implement the necessary changes?

A. At the OCC, we continually look for ways to improve our methods of supervision. Over the years, we have adopted procedures that give us increasing flexibility to assign our resources and focus on the most significant risks to the national banking system. Each national bank is supervised on an ongoing basis. We focus our attention on the largest banking institutions and those that pose the greatest risks to the system. We have introduced automated tools for field examiners and managers. We maintain an up-to-date data base on the condition of each national bank.

The OCC is now in the process of looking at ways we can delegate more responsibility to our examiners with the most detailed knowledge about individual banks. For example, our district offices are delegating authority over certain banks to the field managers and examiners-in-charge in our field offices and duty stations.

We have initiated regulations aimed at strengthening the capital positions of all national banks. The risk-based capital guidelines establish minimum capital levels for banks based on the level of credit risk on their balance sheet and in their off-balance-sheet activities. We are studying ways to enhance those guidelines to incorporate other risks banks assume, including risks that arise from concentrations of credit, interest rate risk, and foreign exchange risk. As we stated earlier, we have also adopted a regulation under which the OCC may close a national bank when its equity capital is depleted, rather than waiting until the allowance for loan and lease losses is also exhausted, as had been our past practice. Timely closure of problem institutions will serve to strengthen the system and minimize the cost of bank failures to the insurance fund. Another improvement of major importance is the enhancement to our enforcement powers contained in FIRREA, which will increase the effectiveness of our enforcement actions.

8. What actions and decisions that you now take independently would be better if coordinated with your fellow regulators?

A. The OCC and the other federal banking regulators work together to meet their independent supervisory and regulatory responsibilities. Coordination and cooperation among the federal regulators of depository institutions occur through informal channels, such as regular meetings of the heads of the regulatory agencies, and through formal structures such as the FFIEC, ICERC, and the Comptroller's and OTS Director's responsibilities to serve as directors of the FDIC and RTC. In addition, our District offices are working with the state regulators in their areas to improve the coordination of efforts and sharing of information where we have joint responsibility in multi-state and multi-charter banking companies.

We coordinate our activities in many areas including training programs, enforcement actions, and regulations. For example, the Federal Reserve Board consults with the OCC on merger or licensing decisions within its jurisdiction that involve holding companies that have national bank subsidiaries. The recent failures of several large regional banks in the southwestern states required an enormous amount of coordination among the OCC, the Federal Reserve Board, and the FDIC. More recently, we have consulted with the Office of Thrift Supervision on some of its regulatory initiatives. In addition, we are currently working with the Conference of State Bank Supervisors, the Federal Reserve, and the FDIC on a pilot program of coordinated examinations. In that program, examinations are done holding company-wide. Examiners from each agency that has supervisory responsibility for a bank owned by the holding company work together to set the scope of the examination, share information, develop a consolidated report, and jointly attend meetings with bank managers and the board of directors. Finally, through the Bank Fraud Working Group, the OCC meets on a regular basis with representatives of the other regulatory agencies and law enforcement community to coordinate our efforts to combat bank fraud. The OCC has been an active member of this working group for the past five years.

Coordination, however, does not imply uniformity. Bank supervision involves judgment, and reasonable people can sometimes disagree about the proper course of action in particular circumstances. Ultimately, the agency with primary supervisory responsibility--the OCC in the case of national banks, the Federal Reserve Board and FDIC in the case of state member banks and state nonmembers, respectively--has to make a decision. Communication among the agencies can ensure that the agency responsible for making a decision has the benefit of the views of the other agencies. When disagreements arise, the agencies not responsible for making a decision have the opportunity to understand why a particular course of action was taken.

9. Recently, several money center banks have substantially increased their loan loss reserves. Are the loan loss reserves held by U.S. banks against their LDC loans adequate? Will you require/encourage banks to increase the reserves they hold against LDC loans? Or will you discourage them? What impact will the increase in reserves have on the Brady Plan?

A. Recent increases in loan loss reserves at several money center banks have substantially raised aggregate reserve levels at the largest LDC lenders. Not all banks, however, hold the same reserve amounts against LDC loans. The assessment of reserve adequacy must be performed case-by-case. That assessment includes an evaluation of a bank's plans for dealing with LDC debt, whether it intends to remain a lender to LDCs over the longer term, and the composition of the LDC debt it holds.

The federal bank regulators have required that U.S. banks hold reserves, known formally as Allocated Transfer Risk Reserves, specifically for loans to a number of LDCs facing protracted debt-servicing problems. In addition, bank supervisors have required banks to maintain adequate levels of general reserves against their loan portfolios, including international credits, as part of the normal supervisory process. Bank supervisors continue to assess closely LDC reserve levels and, as warranted, additional reserves will be requested.

Higher reserves provide banks added flexibility in dealing with their LDC exposures. The ability to absorb discounts readily can expand a bank's LDC restructuring options to include exchanges of loans for collateralized bonds under the Brady Plan as well as loan buy-backs by LDCs.

10. Are you comfortable with: (a) the loan underwriting capacity of the banks that purchase portions of the senior debt that is originated by the large banks in LBO and other highly leveraged transactions; (b) currently applicable accounting principles that govern how banks book the commitment and other fee income associated with their origination of LBO and other highly leveraged transactions; (c) methods banks use to determine their provisions for loan losses on LBO and other highly leveraged transactions; and (d) data availability on LBO's? What steps are you taking to remedy any deficiencies?

A. (a) Financing of leveraged buyouts and other highly leveraged transactions (HLTs) by national banks has been closely monitored by the OCC for the past two years. Our oversight has extended beyond the multinational banks that originate most HLTs to include regional banks that have purchased significant amounts of HLT credits.

During the spring and summer of 1988, the OCC conducted a study of leveraged financing activities at 16 of the largest national banks, including all 11 multinational banks. The purpose of the study was to assess the extent and types of HLT financing by these banks, and to see what specific policies and procedures they had in place to control their HLT exposure. A team of examiners visited each bank and, based on a series of interviews with senior management, prepared a profile of each bank's participation in HLT financing. The study provided the basis for the OCC's Examining Circular 245, which gives detailed guidelines that outline how we believe banks should, at a minimum, structure the process of financing HLTs. The 1988 HLT study also provided the basis for a Leveraged Financing Booklet which describes in detail the practices that the banks surveyed by the OCC have found to be effective in managing their HLT financing activities. Both the booklet and Examining Circular 245 have been distributed to all OCC examiners and to all national banks.

The OCC followed up in the first quarter of 1989 with formal targeted examinations of HLT activities at the 11 multinational banks. The results of those examinations have generally been positive. They did, however, reveal that some regional banks acquire HLT senior debt from multinational banks. Many of those regional banks clearly have the knowledge and the capacity to finance HLTs, but others may not. We are therefore conducting targeted examinations of HLT lending procedures at all regional banks with HLT exposures greater than 2 percent of assets. If those examinations uncover deficiencies in the bank's systems and procedures, the deficiencies will be reported to the senior managers of the bank and corrective action will be required. The quality of those reports will be enhanced with information on the performance of specific HLT credits, which were targeted during the 1989 examination of shared credits. Our examinations of the HLT lending activities of regional banks will be completed during the first half of 1990.

(b) Financial Accounting Standard #91, Accounting for Fees and Costs Associated with Origination or Acquisition of Loans, articulates current accounting principles pertaining to loan fees, including fees related to HLTs. We do not currently have a concern with this standard, and our examination of the 11 multinational banks did not reveal material deviations from this standard.

(c) Examining Circular 245 directs examiners to ascertain (among other things) that banks have considered their HLT portfolios in determining appropriate reserve levels. Our experience to date, based largely on our targeted examination of the 11 multinational banks, is that banks are maintaining adequate reserves against their HLT credits. Most of the banks that we have examined conduct a loan-by-loan analysis of all large credit exposures to determine how much they should reserve for those credits. Some banks also assign increased reserves based on the leveraged nature of HLTs. We encourage both approaches. Given the high proportion of HLT credits held by national banks that are performing, current reserve levels for HLTs appear adequate. Nonetheless, during our examinations, we will continue to encourage banks to take a hard look at their exposures to HLTs and factor that exposure into their reserving. We believe that it is prudent to build reserves for HLTs today so banks will have a cushion if HLT portfolios deteriorate.

(d) When the OCC initially reviewed leveraged buyouts and other highly leveraged transactions at large banks in March, 1988, definitions varied widely among banks. As a result of increased regulatory review and public concern, most banks began to take a broader view of what constituted an HLT. By mid-1989, definitions among banks, while not perfect, were reasonably comparable. To further enhance comparability, the OCC, Federal Reserve Board, and the FDIC issued a joint HLT definition. We have defined an HLT as a transaction that involves the buyout, acquisition, or recapitalization of an existing business if the transaction: a) at least doubles the subject company's liabilities and results in a leverage ratio greater than 50 percent, b) results in a leverage ratio greater than 75 percent, or c) is designated as an HLT by a syndication agent. The joint release is appended to these responses.

As a result of earlier efforts and the new definition, data availability should not be a problem going forward.

QUESTIONS FROM SENATOR GARN

1. The OCC recently announced that enforcement action had been taken against the Bank of New England and the Bank of Boston due to real estate lending problems. Have the problems in these banks now been addressed so that they are on the road to recovery? Can we expect more public actions of this type against other northeast banks in the near future?

A. These actions were disclosed by the Bank of New England and the Bank of Boston, not the OCC. Under FIRREA, the OCC discloses final cease and desist orders, removal actions, and civil money penalties. However, the OCC has a strict policy of not making public disclosures regarding enforcement proceedings that are not yet final or that do not fall into one of these three categories. I would be glad to discuss this matter with you privately, at your convenience.

Given current real estate market conditions in the northeast, other banks in that area are likely to experience weaknesses in their real estate lending portfolios. We expect to see other banks increase their provisions for possible loan losses because of weaknesses in local real estate markets. The OCC is monitoring closely the real estate lending portfolios of banks in the northeast and in some other regions of the country as well. We will take appropriate measures if problems that warrant supervisory action arise.

2. Are you concerned that there may be an over concentration of real estate lending in some sections of the country? Where are these concerns most aggravated? Do you believe that over concentration in any one economic segment creates risks for our financial institutions? Do you believe that it was a mistake to impose a 70% QTL test on thrift institutions? Do you believe that the QTL test will make it more expensive to resolve the problems in the thrift industry?

A. There is no question that rapid growth of real estate loans by banks in the southwest created a concentration of credit--particularly in commercial real estate--that subsequently contributed to the failure of a number of banks in that region. Fundamental supply/demand imbalances remain in southwestern real estate markets; however, construction activity has slowed dramatically, and demand is likely to increase as local economies improve.

More recently, evidence of growing real estate market supply/demand imbalances has become apparent in other sections of the country, including parts of the northeast, southeast, and west. For example, vacancy rates in Boston, Tampa, and Phoenix have increased significantly. Although those weaknesses are not as severe as they have been in the southwest, many national banks find themselves with significant commercial real estate loan exposures, and some have witnessed rising levels of nonperforming real estate loans and real estate loan charge-offs. Provisions for possible real estate loan losses will increase.

As summarized in my written statement of October 25, we are responding to the growth in national bank real estate loan exposure in a number of ways. The steps we have taken reflect our long-held belief that concentrations of credit in any area are a source of potential risk to lending institutions. Analyses of concentrations of credit form a regular part of our program of supervision and are conducted bank-by-bank pursuant to guidelines detailed in Section 216 of the Comptroller's Handbook for National Bank Examiners.

Those guidelines make clear that our goal in supervising concentrations of credit is to ensure that the senior officers in a bank are aware of what concentrations the bank carries and that the added risks those concentrations pose are properly managed. We do this on a case-by-case basis, without a formula, because we recognize that identical concentrations at different banks do not pose identical risks. Two banks with identical volumes of concentrations of credit to the same business sectors, but with different underwriting standards, will likely experience different loss rates on their loan portfolios in those areas of concentration. Banks often knowingly develop concentrations of credit in areas where they have specialized lending expertise; when properly managed, those concentrations do not present undue risks to such banks, and we do not instruct banks to eliminate such concentrations.

Regarding the 70 percent QTL test contained in FIRREA, we understand the motivation behind Congress' imposing such a requirement in light of some of the abuses of lending and investment powers that the thrift industry experienced in the mid-1980s. The QTL test represents an effort to direct the thrift industry back to its traditional role as a provider of residential housing finance.

It is too soon to tell what effect the QTL test will have and whether it will raise the cost of resolving problems in the thrift industry. Philosophically, we believe that financial markets, including the market for housing finance credit, will operate most efficiently when they are not artificially constrained. The QTL test raises the possibility that thrifts will become overly concentrated in residential real estate credit and subject to interest rate risk from maturity mismatches between assets and liabilities.

Nonetheless, the practical effect of the QTL test is that owners of thrifts will decide whether the benefits of a thrift charter outweigh the risks of holding a restricted portfolio. Those who choose not to comply with the test will, over time, become subject to the regulatory requirements that national banks face, and, ultimately, seek to convert to commercial bank charters.

3. **Many of the problems in the thrift industry may be traced to excessive powers granted these institutions by the States, starting in 1980. However, unlike recent proposals in the Senate to pass comprehensive powers legislation for holding companies, the States permitted the institution to engage in the new activities directly. Do you believe that Congress should provide banking institutions with new powers? In what areas would you recommend legislation? What structural safeguards would you propose to safeguard the deposit insurance system from the risks that might be presented by new products and services?**

A. As I have testified on several occasions, banks and their customers would benefit from a lowering of the statutory barriers that separate commercial banking from other forms of financial intermediation. Broader opportunities to participate in securities underwriting, insurance sales, and other currently prohibited activities would provide new ways for banks to diversify their sources of income and strengthen their balance sheets, while providing customers with greater convenience and access to a wider variety of financial services at competitive prices.

The OCC does not believe that the recent experience in the thrift industry implies that securities underwriting and other new powers must be conducted in separately incorporated nonbank affiliates of a bank holding company in order to be safe. While many thrift institutions incurred large losses when they were granted expanded powers, the OCC believes that those losses were due less to the lack of separation between expanded powers and insured deposits than to other factors including government-sanctioned maturity mismatch, which exposed thrift capital to excessive interest rate risk. We do not believe that expanded powers pose the same risk in the banking industry, which is better capitalized and strictly supervised.

Some safeguards are necessary to insulate federally insured deposits from the risks of some expanded bank powers, but it may be possible to provide adequate insulation within the bank's consolidated balance sheet--for example, by setting appropriately high risk-weights in computing capital adequacy or by requiring that some expanded powers be funded with uninsured liabilities--without requiring that expanded powers be conducted in separately incorporated affiliates. Moreover, there are some currently prohibited activities that would pose no significant financial risks for banks and could, therefore, be conducted safely within the bank. On the other hand, there may be other activities which, for both safety and soundness reasons and in the interest of competitive equality, should be conducted either in subsidiaries of the bank or in subsidiaries of its parent holding company. The OCC is currently studying the matter and expects to have more specific recommendations in the future.

4. One of the basic principles behind the recently enacted savings and loan legislation was that the deposit insurance function and chartering function should not be contained in the same agency. However, a potential conflict also exists between the insurance function and regulatory function, since it is to a regulator's advantage to have as many institutions as possible within its jurisdiction. Do you agree that a potential conflict exists between the insurance and the regulatory functions? Would you recommend that the FDIC's regulatory functions be split off from its insurance functions, so that it becomes a pure insurance agency?

A. Assigning responsibility for deposit insurance and bank supervision to two separate government agencies serves an important policy objective: it ensures that a proper balance is struck between the safety of the insurance fund and the need for competition and innovation in the market for financial services.

The current division of responsibilities between the supervisor and the insurer works well, and we would not recommend any changes now. It ensures that the safety of the insurance fund will be balanced against the need to allow competition and innovation in the market for financial services. One objective will not dominate the other.

The charterer/supervisor is more likely to be receptive to measures that will increase competition, such as entry into new markets or new lines of business. Similarly, the bank supervisor is more likely to look favorably upon innovations that, although they entail some risks, will enable banks to adapt in the long run to changing demands for financial services, particularly as important competitors in Europe and Japan are granted new powers.

In contrast, a deposit insurer's most immediate--and appropriate--objective is to maintain the insurance fund at a high level. The best environment from the perspective of the insurer would be a banking system in which there were no failures, so that the insurance fund would never shrink. Thus, the insurer naturally views banking activities in terms of the threats they may pose to the insurance fund. Consequently, the insurer's instincts, as long as the fund is solvent, are to take a more conservative approach to bank supervision, and to tend to resist innovative, but unproven, products because of their uncertain effects on the rate of bank failures.

Obviously, bank supervisors do not ignore the risks taken by insured institutions. The OCC recognizes the potential dangers to the banking system and the insurance fund when bankers fail to manage properly the risks they assume. In fact, it is arguably our most important role, in preserving the safety and soundness of the banking system, to close promptly institutions that, despite the supervisor's and the bank's efforts, have become insolvent. In that way we can ensure that the bank's shareholders and uninsured creditors, rather than the Bank Insurance Fund or the public, bear most of the losses. Just as clearly, the supervisor's chartering responsibilities will not inevitably lead it to be permissive in order to increase the value of charters. On the contrary, we know that lax supervision depreciates the value of charters and penalizes healthy, well-managed institutions.

It should be noted that the FDIC has safeguards against supervisory activities with which it disagrees. The FDIC, upon the order of the Board of Directors, is authorized to examine national banks and state-chartered banks that are members of the Federal Reserve System. The FDIC also has the authority to terminate deposit insurance in a state-chartered or national bank. This ability to terminate insurance should be the FDIC's principal remedy, with intermediate remedies left to the primary supervisor of the bank.

5. Do you believe the examination force of your agency is sufficient to closely monitor the conditions of banks within your primary jurisdiction? What percentage of such institutions are examined on a yearly basis? On a bi-yearly basis? Less frequently? Do you believe it would be prudent to increase the frequency of bank examinations?

A. We believe that our examination force is of sufficient size to monitor national banks. However, we do need to strengthen the force by building our experience levels and by increasing the proportion of commissioned examiners at the OCC. Because of the long lead time needed to train examiners, it will take some time until we have the desired number of commissioned examiners. Therefore, the most serious challenge for the OCC is to attract and retain experienced staff.

Following the passage of the FIRREA legislation, we made some interim compensation changes after consulting with the other federal bank regulatory agencies. We are undertaking an extensive study of our compensation program, and we expect to make permanent changes after the completion of that study this year. With a competitive compensation program, we believe that the OCC will be able to continue to build and maintain an examination staff with the knowledge and experience needed to meet the challenges of the future.

Regarding the frequency of examinations, it must be understood that the OCC does not schedule examinations of national banks on a calendar basis. Instead, each national bank receives ongoing supervision as appropriate. We review each national bank to determine its risk profile and the threat the bank is believed to pose to the national banking system. Each bank is then assigned to a particular risk level, and we allocate supervisory resources accordingly. This form of risk-weighting allocates the most resources to the largest banking institutions (those which present the greatest systemic risk) and those with the most significant levels of problems.

OCC examiners are on-site continuously in each multinational bank in the system, and we focus a substantial amount of examination resources on the large regional banking institutions. Any bank that has serious problems, or that is near failure or approaching failure, receives extra supervisory attention. Where enforcement or supervisory actions have had a rehabilitative effect on problem banks, supervisory attention involves monitoring for continued improvement. Furthermore, our ongoing supervision includes a written communication regarding our conclusions about the overall condition of the bank, which is provided at least annually to the board of directors of each national bank. The conclusions contained in this communication are based upon the supervisory activity which we have conducted regarding that bank during the time period covered.

We believe that the focus of our supervisory process is appropriate. Our process is continuing to evolve, and as the experience level of our examination staff increases, so will our effectiveness and efficiency.

6. In your testimony you discussed the improved earnings at national banks for the first half of the year. Have the large loan loss provisions for LDC debt, LBO debt, and real estate debt in the third quarter at many large banks eliminated these gains?

A. No. The loan loss provisioning you cite largely affects the 28 largest national banks--those with assets exceeding $10 billion at September 30, 1989. As a group, those banks reported net income of $0.5 billion in the third quarter compared to $3.0 for the first six months of 1989.

Those positive third quarter earnings were achieved despite the significant provisions for loan loss that the banks made during the third quarter. For the third quarter, they set aside $1.7 billion for loan losses, compared to $1.3 billion in the first two quarters of 1989.

QUESTION FROM SENATOR PRESSLER

1. I continue to be greatly concerned over LBOs or Highly Leveraged Transactions (HLTs). I am concerned over their affect on the economy, loss of tax revenues, and what they may portend for our financial institutions. In the regulatory activities of the federal government what specific definition do we have for an HTL? Is it a definition that is uniformly applied among the regulatory agencies or what differences are there? What is being done among the regulatory agencies to limit bank investment in HTLs?

A. During the spring and summer of 1988, the OCC conducted a study of leveraged financing activities at 16 of the largest national banks. The purpose of the study was to assess the extent and types of HLT financing by these banks, and to see what specific policies and procedures they had in place to control their HLT exposure. A team of examiners visited each bank and, based on a series of interviews with senior management, prepared a profile of each bank's participation in HLT financing. The study provided the basis for the OCC's Examining Circular 245, which directs examiners to ensure that banks adopt adequate policies and procedures regarding leveraged financing.

Examining Circular 245 emphasizes that a vital part of adequate policies are limits on HLT exposures. The OCC recommends limits for equity and mezzanine activity, such as subordinated debt, as well as for senior debt. More broadly, all HLT activities are governed by lending and investment limits set by law or regulation. The lending-limit provision of 12 USC 84 restricts unsecured loans to a single borrower to 15 percent of the bank's capital and surplus; loans secured by readily marketable collateral are permitted up to an additional 10 percent of capital and surplus. Most of the major banks engaged in HLT lending have internally imposed limits that are well below the statutory limit.

We are in process of conducting targeted examinations of HLT activity at national banks with HLT exposures greater than 2 percent of assets. After those reviews are complete, we will know each bank's limits and be better able to judge whether they are appropriate and whether the banks are adhering to them.

Regarding the definition of HLTs, in October the federal bank regulatory agencies jointly adopted a common definition to be used by examiners. For our purposes, an HLT involves the buyout, acquisition, or recapitalization of an existing business if the transaction: a) at least doubles the subject company's liabilities and results in a leverage ratio greater than 50 percent, b) results in a leverage ratio greater than 75 percent, or c) is designated as an HLT by a syndication agent. The joint release is appended to these responses.

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BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Definition of Highly Leveraged Transactions (HLTs)

To: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examiners

The federal bank regulatory agencies have jointly adopted a common definition of highly leveraged transactions (HLTs) to be used by examiners in reviewing bank financing of such transactions. A copy of the definition is attached.

The regulators believe that a common definition will facilitate supervision of bank HLT activities, assist banks interested in comparing their HLT financing activities with those of their peers, and remove obstacles for investors and others interested in tracking the growth of bank involvement with HLTs.

For more information about the definition, contact:

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Senior Deputy Comptroller
Bank Supervision Operations

Attachment

Date: October 30, 1989

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Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System have jointly adopted a common definition of highly leveraged transactions (HLTs) as part of a coordinated effort to provide more effective supervision of bank involvement in these transactions.

BACKGROUND

As a result of growing public interest and increased supervisory concern about HLTs, the banking agencies have individually initiated supervisory activities and provided guidance to examiners about the special risks associated with this kind of financing. The regulators did not issue a definition of HLTs for supervisory purposes because bank involvement in HLTs was relatively recent and varied widely. In the absence of such a definition, banks adopted a wide range of definitions, some of which excluded transactions that were of interest to the supervisory agencies. Lack of a common definition created problems for supervisors, for banks themselves, which wanted to compare their own performance with that of their peers, and for investors and others interested in tracking the growth of bank involvement in highly leveraged financing.

In developing a common definition for HLTs, the agencies recognized that transactions, industries, and individual companies differ, and that several factors may be considered in classifying a transaction as an HLT. In the regulatory definition, the principal classification criterion is the purpose of the transaction. That is, transactions that involve a buyout, acquisition, or recapitalization of an existing business would be candidates for inclusion as an HLT. A second criterion for HLT classification is whether the transaction is accomplished with a significant debt increase and results in a high level of leverage.

The borrowing company's ability to deal with a substantially higher debt burden is of primary importance, but the relative level of that debt is also significant The existence of higher debt levels requires companies to perform in a more rigid environment, in a more efficient manner, and with a lower margin for error.

The determination of what constitutes a significant debt increase or high leverage depends on a variety of factors that may not be consistent for all industries and companies and may be subject to change. Nonetheless, the regulatory agencies believe it is desirable to have a common definition of what constitutes an HLT. Adoption of a uniform definition by the three federal banking agencies will not only facilitate supervision of bank HLT activities, but also help banks by providing a common standard for tracking their own activities and comparing them with those of their peers.

DEFINITION

For supervisory purposes, a bank or bank holding company is considered to be involved in a highly leveraged transaction (HLT) when credit is extended or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business. In addition to this purpose test, one of the following criteria must be met for the transaction to be considered an HLT:

- o The transaction at least doubles the subject company's liabilities and results in a leverage ratio higher than 50%.
- o The transaction results in a leverage ratio higher than 75%.
- o The transaction is designated an HLT by a syndication agent.

In those cases where a credit meets the purpose test but is not covered by any of the criteria above, the bank supervisory agencies may nevertheless designate the credit as an HLT. It is anticipated that this would be done infrequently and only in material cases.

The agencies will include all obligations of, and claims on, HLT borrowers, regardless of perceived credit quality or secured status.

The leverage ratio is total liabilities divided by total assets. Total liabilities include all forms of debt and claims, including all subordinated debt and non-perpetual preferred stock. Total assets include intangible assets.

POLICY

The three federal banking agencies are distributing this definition of HLTs to all their examining personnel for use in supervising HLT activities in commercial banks. In addition, copies of the definition are being sent to banks to increase their understanding of how the regulators define these transactions.

Marriott

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